

A photograph of several wind turbines in a field at sunset. The sky is a mix of orange, pink, and blue. The turbines are dark silhouettes against the bright sky. The image is partially covered by a white circular graphic on the right side.

Do Sustainability-linked bonds have a step-up problem?

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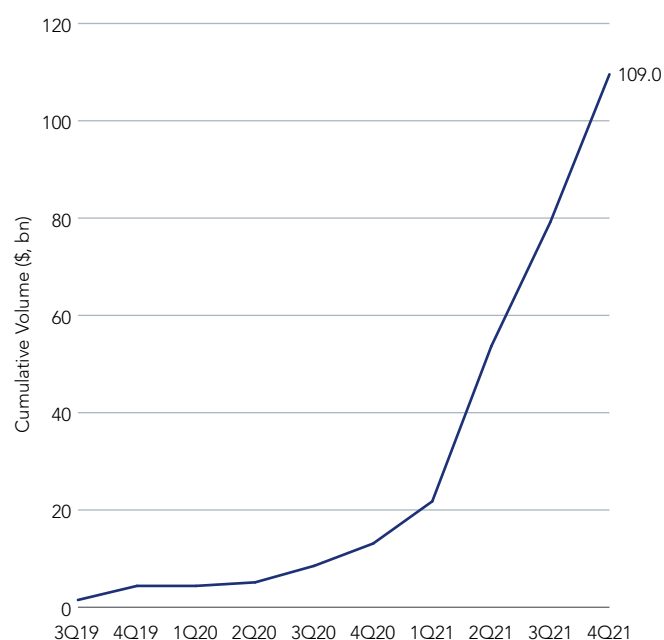
Summary Points

- Sustainability-linked bonds (SLBs) have grown rapidly over the last year
- The market's preferred mechanism for punitive fees when a company misses sustainability targets is a coupon step-up, most often set at 25 basis points
- Because the flat rate of 25bps doesn't consider the scale of a business, the materiality of this as an incentive is inconsistent across companies, and thus undermines credibility of the market
- To facilitate the growth and protect the health of the SLB market we suggest replacing the fixed 25bps step-up with a feature that flexes with the scale of the issuing company

After record issuance in 2021, the Green, Social, and Sustainability bond market (GSS) has grown to a market capitalisation of just under \$2tn¹. The fastest growing security-type in this market is the sustainability-linked bond (SLB). The bonds debuted in 2019 by Enel, an Italian utility company – and, by the following year, companies had issued some \$10bn of SLBs into capital markets. By 2021, that figure had risen more than ten-fold and expectations are for a similar or even higher level of issuance this year. Without question, SLBs have found a permanent place as part of the GSS market

Unlike 'use of proceeds' bonds, such as green bonds and social bonds, proceeds from SLBs can be used for general corporate purposes (GCP). SLB issuers attach their cost of capital to sustainability by having to pay punitive changes to debt service obligations if they miss specific sustainability targets. As we will discuss in detail, the materiality of that cost-of-capital effect depends on several variables and, in aggregate, conveys the message of how serious the issuer is about sustainability.

Figure 1: Growth of the sustainability-linked bond market



Source: Federated Hermes, Bloomberg. 31 December, 2021.

The SLB: As defined by the International Capital Markets Association (ICMA)²

Sustainability-linked bonds (SLBs) are any type of bond instrument for which the financial and/or structural characteristics can vary depending on whether the issuer achieves predefined sustainability/ESG objectives. In that sense, issuers are thereby committing explicitly (including in the bond documentation) to future improvements in sustainability outcome(s) within a predefined timeline. SLBs are a forward-looking, performance-based instrument.

Figure 2: Summary aspects of GSS bonds

	Use of Proceeds	Structure	Use of Proceeds
'Use of Proceeds' Bonds – green, social, blue, sustainability	'Eligible Projects' defined by framework	Typical	Reporting on allocation of proceeds, impact of projects
Sustainability-Linked Bonds (SLBs)	General corporate purposes	Structure linked to achievement of Sustainability Performance Targets (SPTs)	Reporting on KPI performance, any impacts on bond characteristics



Source: Federated Hermes, ICMA.

¹ Natixis. Credit Research: Green & Sustainable Outlook 2022 (January 2022).

² Sustainability-Linked-Bond-Principles-June-2020-171120.pdf (icmagroup.org).

Love them or leave them

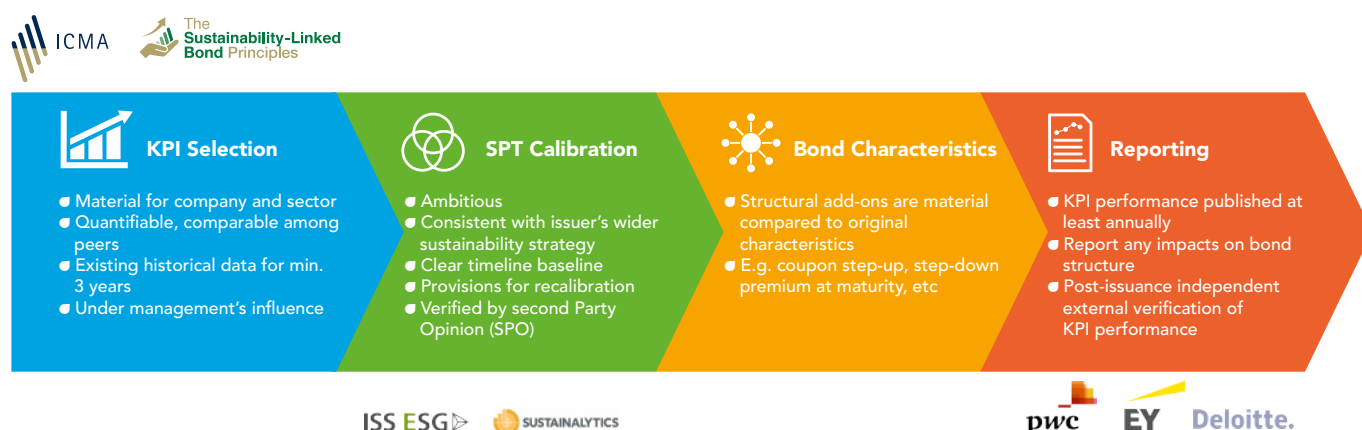
SLBs have attracted a Marmite-like reputation: market participants either love them or hate them. Some take issue with the fact that proceeds of these sustainability-linked securities can be used for any corporate purpose that the issuer decides – sustainable or not. Others point to a lack of ambition in the sustainability targets the companies set for themselves, or note that issuers' self-imposed, punitive features (e.g., coupon step-ups) lack financial materiality. On the other hand, proponents of SLBs highlight how companies in hard-to-abate sectors – or those that have no specific 'green' projects – now have a path to align their sustainability objectives with their cost of capital. For these issuers, SLBs provide an opportunity to demonstrate their seriousness about sustainability.

Whether for valuation reasons we chose to buy an SLB or not, our own credit and sustainability analysts see value in the structure as a means of determining the likelihood of a company converting the potential for positive change into actual, realised change. As such, SLBs, along with other GSS bonds, serve as another piece of information to assess and score the sustainability credentials of the issuer.

Baby steps to the step-up

That there is open, earnest debate around the SLB market reflects its nascency; it has yet to mature into a fully developed market governed by widely accepted norms. The International Capital Markets Association (ICMA) has published several excellent framework documents that establish best-in-class principles, structure and key performance indicators (KPIs) for such bonds³. Even so, no matter the structure, bond issuers set their own level of ambition and accountability via sustainability performance targets (SPTs) and KPIs and bond structure. In coordination with their relationship banks, they also set changes in financial features of the bonds were the issuer to miss those SPTs. As a result, the components of SLBs have been largely designed between companies and banks with little input from the buy-side. However, as we do with the financial aspects – structure, covenants, documentation – of any bond, we investors must assess the features of an SLB and determine what it says about the ambition and accountability of the issuer's sustainability policies and actions.

Figure 3: Typical features of a sustainability-linked bond



³ Sustainability-Linked-Bond-Principles-June-2020-171120.pdf (icmagroup.org); Sustainability-Linked Bond Principles (SLBP) (icmagroup.org)

As we have stated in previous commentary and above, though we are not forced buyers of any security, we remain favourable to the SLB market⁴. Now that the market has grown to modest scale and patterns have emerged, we are much better placed to opine about where and how it is evolving. To that end, we have built our own SLB database that captures nearly 200 securities with a notional value of some \$110bn⁵. This has given us the ability to compare the relative strength in ambition and accountability of the issuers who place SLBs into the market. In the appendix of this brief commentary, we include charts that paint a picture of how the market has evolved to date.

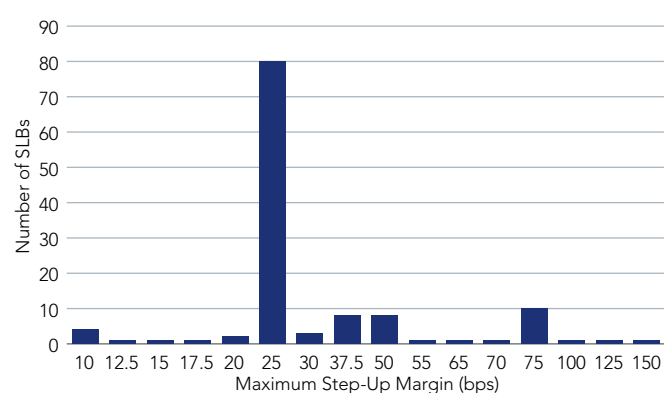
Stepping into the debate on step-ups

In the interest of brevity, we focus only on one particular SLB feature: the coupon step-up, chosen by 85% of SLB issuers that we captured in our database. Because of its messaging to the investor about ambition and accountability, this is an important part of SLB design. Also, given that we observe certain patterns in analysing step-ups based on the data in our SLB database, we think it requires commentary.

As we note above, the vast majority of SLBs come with coupon step-up language. What we are trying to understand is why, as Figure 4 below shows, the SLB market appears to be consolidating around 25bps as the size of the step-up, regardless of coupon size or credit quality or scale of the issuer⁶.

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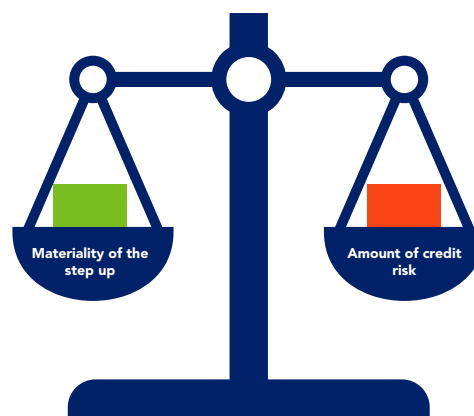
Figure 4: Distribution of maximum coupon step-up for SLBs



Source: Federated Hermes, Bloomberg. 31 December, 2021. If an SLB has multiple step-ups, we've summed them up because that is a reflection of the maximum step-up that an SLB-issuer is willing to pay.

From an investor's perspective, the coupon step-up needs to balance two factors: materiality and credit risk. On the one hand we want to see a step-up that is material. However, on the other hand we do not want to see a step-up that puts so much pressure on the cashflow of the business that its triggering would meaningfully increase credit risk. This is a difficult balance to strike since the point at which the step-up elevates credit risk will vary from company to company.

Relative to the coupon, for instance, 25 basis points could be a large number for highly rated investment-grade companies, where coupons in European bonds could be less than one percent. In this case, 25 basis points is material versus the base coupon. However, it is also easily managed by a strong investment-grade company which may not even notice a step-up of such small size relative to its cash flow. For a high yield company, where a coupon could be 5% or 6%, in relative terms 25 basis points feels rather small. But, that doesn't matter as much as the impact on a liquidity for a smaller, more credit-challenged entity that a 25-basis-point step-up would generate.



With over 60% of SLB step-ups set at 25bps in aggregate, the market norm is consolidating around a fixed level for the step-up, which fails to consider the trade-offs described above. The financial materiality of a 25-basis-point step-up will vary depending on the cost of capital and credit strength for the issuing company, and thus has an unequal effect as an incentive. The investment grade company that misses an SPT may face headline risk, but no financial risk; whereas a high yield company could face both.

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⁴ Enel steps up: the world's first SDG-linked bond - Hermes (hermes-investment.com); Sustainability-linked bonds get the green light | Federated Hermes (International) (hermes-investment.com)

⁵For analytical purposes, we exclude issuances of less than \$100m and private placements for which we cannot obtain governing documentation.

⁶In analysing the SLB database, it's quite obvious that many SLB issuers structure the bonds with more than one SPT. However, as a means to understand what the maximum tolerance for the SLB issuer to pay up for missing an SPT, we have summed up each of the step-ups embedded in a bond and presented them in distribution format in Figure 4. For example, some of those in the 25-basis-point bucket represent the summing up of two 12.5 basis points step-ups.

We fear that insouciant acceptance of the 25-basis-point step-up as a norm will eventually undermine investors' confidence in the SLB market and, worse, this could weaken the ability of the asset class to align capital markets with corporate sustainability. In setting an SPT, issuers must strike a balance between protecting their capital structures and providing meaningful, material backing to their sustainability objectives.

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A new approach

There is no shortage of the use of step-ups in debt capital markets: loan ratchets based on changes in credit metrics; step-ups attached to companies that are downgraded to high yield from investment grade; the step-up structure in the contingent convertible bond market (CoCo), and so on. Given its widespread presence in finance culture, it makes sense that bankers and issuers reach for the step-up structure.

We don't have a general problem *a priori* with the step-up as a mechanism to channel to bondholders the premium payments based on the occurrence of certain events. However, our view is that, as discussed above, depending on the size of the business, a flat 25-basis-point step-up can run the range from material to insignificant. The strength of the fixed-sized step-up is therefore relative to the scale of a company: hardly a financial incentive for large companies, yet material for smaller ones.

Compounding the problem of delivering into global sustainability objectives, the companies for whom a 25-basis-point step-up is immaterial are large and therefore much more likely to have a meaningful impact on society and the

environment. To these companies, the 25 basis points step-up is a weak financial incentive to hit an SPT. And, yet, missing them is likely to have a more important impact on society and the environment than if smaller companies were to miss targets.

Scale the pain to create positive change

In our view, the solution to the problem is to more appropriately align the step-up of the sustainability-linked bond to the scale of the company. In this way, we can address the problems outlined above. If the step-up were more meaningful to companies of scale than 25 basis points, they would be much more concerned about missing the SPTs (albeit at the risk of setting unambitious targets). And, as noted above, this would better serve the overall global effort to support sustainability, particularly the fight against climate change.

Of course, this then raises the question: What is the method to measure the scale of the business. Options for indications of scale could be market capitalisation or revenue or amount of debt. Given that this is credit investing, where operating cash flow is both a measure of credit strength and scale, we suggest the calculation of the step-up be based on a percentage of the EBITDA of the issuing company.

It also makes sense that the step-up consider the *pro rata* share that the SLB represents in the debt capital structure. Predicated on these ideas, we have mocked up two scenarios—investment-grade and high yield—for what this could look like (see Figure 5). We did this in order to better understand how this approach affects 1) the materiality of the step-up feature and 2) credit risk, as measured by net leverage. We also wanted to better understand how this approach affects the balance between these two outcomes—materiality and credit risk.

The so-called sweet spot for us sits at the union of a bit of pain for missing the SPT, but avoiding serious degradation of credit fundamentals. The second order effects of weakening a company based on an excessively weighty coupon step-up could actually undermine success in delivering into a sustainability agenda, and worse, create new social problems, e.g., job layoffs, business closures, services not offered.



Figure 5: Balancing % of EBITDA vs % of SLBs in the debt capital structure

SLB as % of Cap Structure											
50%											
Example 1: Investment Grade (\$, mm)											
SLB payment as a % of EBITDA		1%	2%	3%	4%	5%	6%	7%	8%	9%	10%
EBITDA	25,000	25,000	25,000	25,000	25,000	25,000	25,000	25,000	25,000	25,000	25,000
Total Debt	50,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000
SLB Adjustment based on % factor		250	500	750	1,000	1,250	1,500	1,750	2,000	2,250	2,500
Assumes 50% SLB		50%	50%	50%	50%	50%	50%	50%	50%	50%	50%
Pro rata share to SLB		125	250	375	500	625	750	875	1,000	1,125	1,250
SLB Adjusted Debt		50,125	50,250	50,375	50,500	50,625	50,750	50,875	51,000	51,125	51,250
SLB Adj Net Leverage*	2.00x	2.01x	2.01x	2.02x	2.02x	2.03x	2.03x	2.04x	2.04x	2.05x	2.05x
SLB payment as a % of EBITDA		1%	2%	3%	4%	5%	6%	7%	8%	9%	10%
Penalty as % of Net Debt											
SLB = 10% of Cap Structure		0.05%	0.10%	0.15%	0.20%	0.25%	0.30%	0.35%	0.40%	0.45%	0.50%
SLB = 20% of Cap Structure		0.10%	0.20%	0.30%	0.40%	0.50%	0.60%	0.70%	0.80%	0.90%	1.00%
SLB = 30% of Cap Structure		0.15%	0.30%	0.45%	0.60%	0.75%	0.90%	1.05%	1.20%	1.35%	1.50%
SLB = 40% of Cap Structure		0.20%	0.40%	0.60%	0.80%	1.00%	1.20%	1.40%	1.60%	1.80%	2.00%
SLB = 50% of Cap Structure		0.25%	0.50%	0.75%	1.00%	1.25%	1.50%	1.75%	2.00%	2.25%	2.50%
SLB = 60% of Cap Structure		0.30%	0.60%	0.90%	1.20%	1.50%	1.80%	2.10%	2.40%	2.70%	3.00%
SLB = 70% of Cap Structure		0.35%	0.70%	1.05%	1.40%	1.75%	2.10%	2.45%	2.80%	3.15%	3.50%
SLB = 80% of Cap Structure		0.40%	0.80%	1.20%	1.60%	2.00%	2.40%	2.80%	3.20%	3.60%	4.00%
SLB = 90% of Cap Structure		0.45%	0.90%	1.35%	1.80%	2.25%	2.70%	3.15%	3.60%	4.05%	4.50%
SLB = 100% of Cap Structure		0.50%	1.00%	1.50%	2.00%	2.50%	3.00%	3.50%	4.00%	4.50%	5.00%
Example 2: High Yield (\$, mm)											
SLB payment as a % of EBITDA		1%	2%	3%	4%	5%	6%	7%	8%	9%	10%
EBITDA	250	250	250	250	250	250	250	250	250	250	250
Total Debt	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000
SLB Adjustment based on % factor		2.5	5.0	7.5	10.0	12.5	15.0	17.5	20.0	22.5	25.0
Assumes 50% SLB		50%	50%	50%	50%	50%	50%	50%	50%	50%	50%
Pro rata share to SLB		1.25	2.50	3.75	5.00	6.25	7.50	8.75	10.00	11.25	12.50
SLB Adjusted Debt		1,001	1,003	1,004	1,005	1,006	1,008	1,009	1,010	1,011	1,013
SLB Adj Net Leverage*	4.00x	4.01x	4.01x	4.02x	4.02x	4.03x	4.03x	4.04x	4.04x	4.05x	4.05x
SLB payment as a % of EBITDA		1%	2%	3%	4%	5%	6%	7%	8%	9%	10%
Penalty as % of Net Debt											
SLB = 10% of Cap Structure		0.03%	0.05%	0.08%	0.10%	0.13%	0.15%	0.18%	0.20%	0.23%	0.25%
SLB = 20% of Cap Structure		0.05%	0.10%	0.15%	0.20%	0.25%	0.30%	0.35%	0.40%	0.45%	0.50%
SLB = 30% of Cap Structure		0.08%	0.15%	0.23%	0.30%	0.38%	0.45%	0.53%	0.60%	0.68%	0.75%
SLB = 40% of Cap Structure		0.10%	0.20%	0.30%	0.40%	0.50%	0.60%	0.70%	0.80%	0.90%	1.00%
SLB = 50% of Cap Structure		0.13%	0.25%	0.38%	0.50%	0.63%	0.75%	0.88%	1.00%	1.13%	1.25%
SLB = 60% of Cap Structure		0.15%	0.30%	0.45%	0.60%	0.75%	0.90%	1.05%	1.20%	1.35%	1.50%
SLB = 70% of Cap Structure		0.18%	0.35%	0.53%	0.70%	0.88%	1.05%	1.23%	1.40%	1.58%	1.75%
SLB = 80% of Cap Structure		0.20%	0.40%	0.60%	0.80%	1.00%	1.20%	1.40%	1.60%	1.80%	2.00%
SLB = 90% of Cap Structure		0.23%	0.45%	0.68%	0.90%	1.13%	1.35%	1.58%	1.80%	2.03%	2.25%
SLB = 100% of Cap Structure		0.25%	0.50%	0.75%	1.00%	1.25%	1.50%	1.75%	2.00%	2.25%	2.50%

* For simplicities sake, we assume cash balance is zero. As such, gross debt and net debt are the identical in this scenario analysis.

Source: Federated Hermes. NB: On the accounting treatment of the step-up based on this model we propose, the additional payment would be treated as a financial expense. It would, therefore, not affect the calculation of EBITDA. It would, of course, be a use of cash and—*ceteris paribus*—bring down the amount of cash on the balance sheet. This would in turn lead to a rise in net debt and thus leverage.



In generating these two scenarios displayed in Figure 5, we discovered that the materiality of the payment feature and changes to credit risk are principally governed by two key considerations: 1) the percentage of SLBs that comprise the debt capital structure and 2) the percentage of EBITDA that the payment feature covers.

For example, in taking the midpoint of the investment grade example of Figure 5, 50% of the debt capital structure at 5% of EBITDA would lead to a increase of net leverage from 2.0x to 2.03x⁷, which, in our view, is a pretty small rise in credit risk as measured by net leverage.

In all cases in Figure 5, we assume the payment adjustment for a missed SPT is only paid out to owners on record of the SLBs itself. As such, the payment is made on a *pro rata* basis (with the rate being set at the percentage of SLBs in the debt capital structure and based on the percentage of EBITDA set in the terms of the bond).

In looking at Figure 5, you could go all the way to a '10% by 100%' structure and credit risk still would not rise more than .1x turns of leverage. And while the notion of the sweet spot – the right balance between materiality and changes to credit risk – will vary from one investor to another, we think anywhere from the yellow range to the green range of the heat maps in Figure 5 covers that sweet spot with the '5% by 50%' at the centre of it⁸.

To further illustrate the impact on a specific company's financial risk, see Figure 6 for a 'real world' case study that we have created for illustrative purposes. Here we have carved out one issuer from our SLB database, Rexel SA, for whom we compare the impact of shifting from a 25-basis-points step-up structure to a '5% x 47%'.

As you can see, the jump from an estimated €2.5m impact of the 25-basis-points step-up to the €24.3m based on a scaled step-up is notionally material. However, with net leverage as a measure of credit risk the impact on risk when shifting from 25 basis points to the '5% x 47%' approach is low at .03x, as shown in Figure 6.

Figure 6: Case study comparing 25 basis points versus '5% x 47%' step-ups

Case Study: Rexel SA (€, mm)	
FY 2021	
Total Financial Debt	2,128
Less: Cash	-573
	1,555
LTM Adj EBITDA	1,035
Net Leverage	1.50x

Proforma for 25bps step-up (in aggregate per bond)	
25bps	0.25%
Two SLB o/s	1,000
Step-up payment at 25bps	2.5
Adjusted Net Debt	1,558
LTM Adj EBITDA	1,035
Net Leverage as adjusted for step-up	1.50x

Proforma for 5% of EBITDA	
% of EBITDA	5%
LTM Adj EBITDA	1,035
Base of Step up charge	52
Gross debt as at Dec 31 2021	2,128
Adj for % of SLBs in Cap Structure	47%
Notional value of two SLBs	1,000
% of debt capital structure that are SLBs	47%
Step-up payment based on 5%x47%	24.3
Adjusted Net Debt	1,579
LTM EBITDA	1,035
Net Leverage as adjusted for step-up	1.53x

Source: Estimates. Federated Hermes, Rexel.
<https://www.rexel.com/en/finance/documentation/>
 Intended for illustrative purposes.

⁷ For accounting purposes, we assume the SLB adjustment would be treated as a 'below the line' financial expense and therefore would not affect the calculation of EBITDA. However, it would of course affect cashflow and therefore net leverage as the increase in the use of cash would lead to a decline in cash on the balance sheet and therefore a rise in net debt.

⁸ There is a non-linear effect of this method in IG versus HY. The '5% by 50%' rule will have a differing impact on credit risk depending on the underlying leverage. We can see this by comparing the IG sample versus the HY sample on the heat maps in Figure 5. For the 5x50 spot, credit risk – as measured by leverage – increases by 1.5% while for a 5x50 HY name, the increase is lower at 0.63%. (Admittedly, credit risk is non-linear, so a 0.63% of a high leverage could be as material as 1.5% increase of a low leverage, but this is still worth pointing out.) Having said all of that, we are comfortable with IG names (i.e., lower credit risk) having a higher penalty as we discuss in the note.

We admit that this concept is not fully formed as of yet and that it could introduce more bond-price volatility in the secondary market for those companies that fail to hit their SPTs versus the 25bps approach. Nonetheless, this approach (or this type of approach) is more appropriate than a market forming around an agnostic, fixed-priced 25bps step-up – or any fixed amount for that matter.

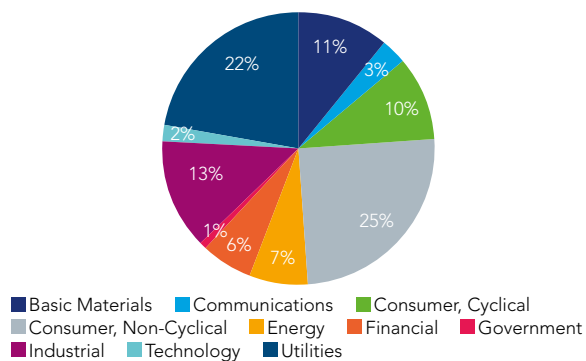
Our view is that the ‘norm’ of a 25bps step-up is untenable, and, frankly, unhealthy for the development of the SLB market for the reasons noted above. Our proposed method allows issuers of SLBs the opportunity to present their sustainability objectives with confidence and accountability – no matter the size of the company. We know there are some strong opinions around the definition of ‘materiality’. To address that, we have offered a solution that creates a range for materiality generated by dialling up or down two forces linked to the scale of a company.

We hope that emerging from this debate around structure for SLBs, solutions will emerge – such as the one suggested here – that mitigate accusations of so-called greenwashing in the SLB market and thus reinforce the market’s ability to continue to grow and align corporate activity with sustainability.

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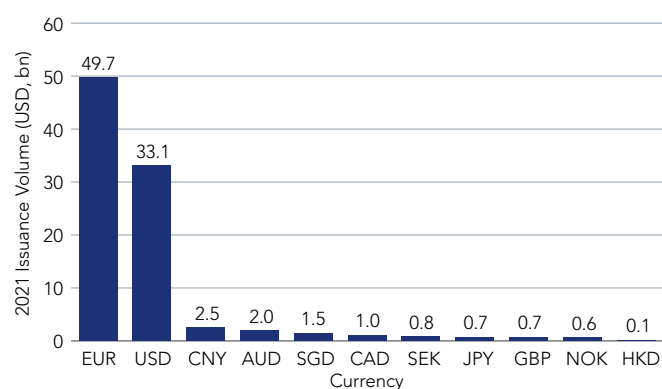
Appendix

Figure 7: SLB issuance by sector



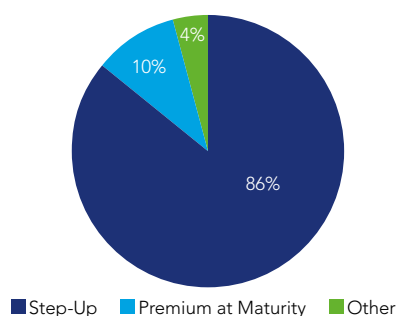
Source: Federated Hermes, Bloomberg. 31 December, 2021.

Figure 8: SLB issuance by currency



Source: Federated Hermes, Bloomberg. 31 December, 2021.

Figure 9: Issuance by structural feature



Source: Federated Hermes, Bloomberg. 31 December 31, 2021.



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- **Stewardship:** corporate engagement, proxy voting, policy advocacy

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