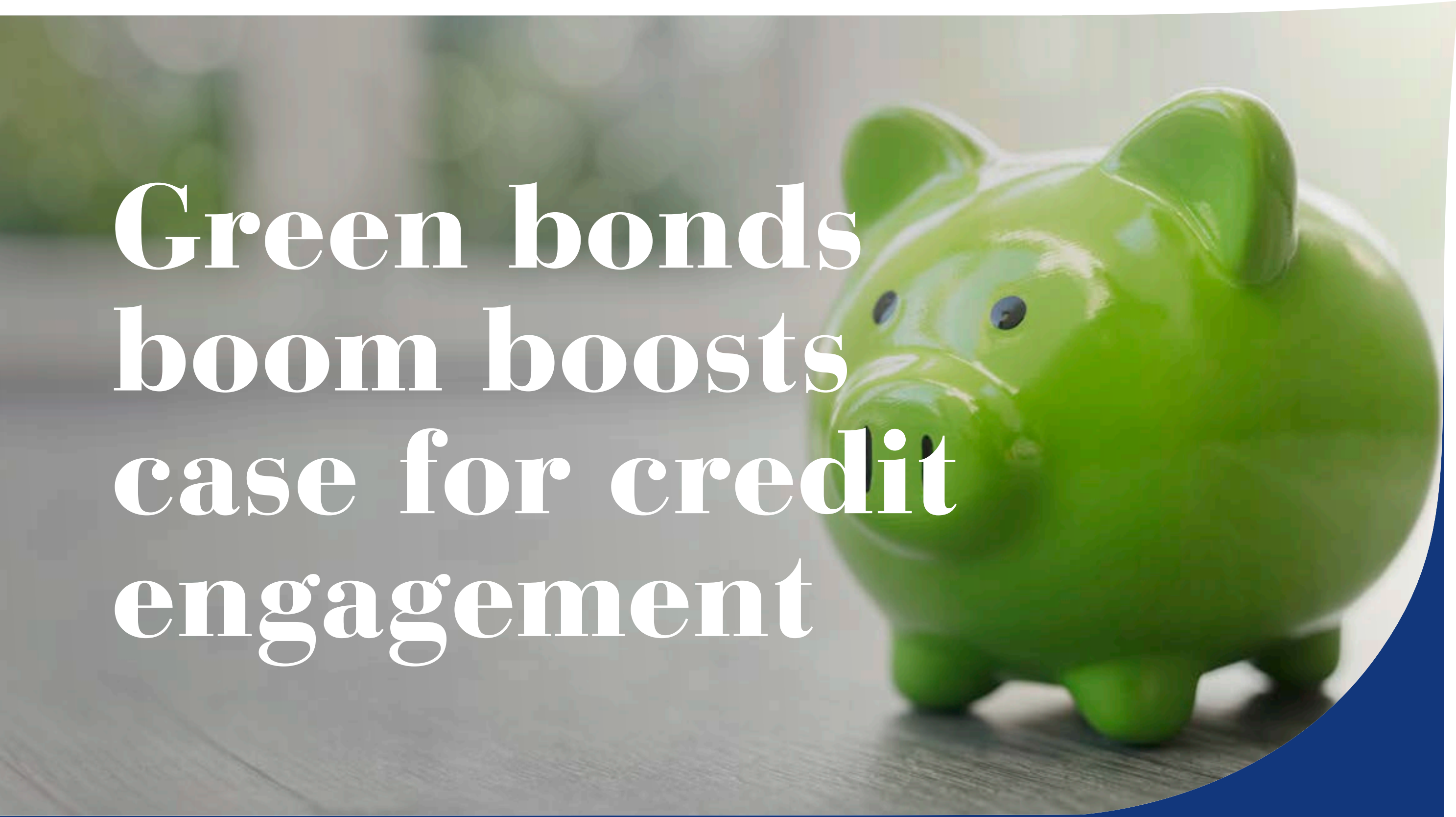

Green bonds boom boosts case for credit engagement

We have engaged with companies on behalf of bondholders for many years, recognising that credit portfolios can be hard hit in the wake of serious controversies. Ross Teverson explains how we have evolved our engagement approach as the size of the sustainable bond market has grown.

Setting the scene

In 2018 and 2019, EOS and Federated Hermes Limited's credit team published a two-part paper, entitled *We Can All Get Along*.[1,2] This asserted that the shared interests of bond and shareholders in companies provide incentives to jointly engage with them – generating positive outcomes by doing so. Over the past five years, growing awareness of long-term sustainability considerations, developments in policy and market best practice, and our own experience of engaging with companies, have strengthened our conviction in the value of engagement across the capital structure.

Our original paper argued that the financial stake held in companies by bondholders and long-term shareholders gives them the legitimacy to engage, and arguably an obligation to do so. It also posited that the interests of financial stakeholders in the sustainable growth and long-term health of businesses are aligned, enabling them to jointly engage companies.

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Poorly managed ESG factors, including corporate governance, can destroy value for equity and bond investors, as demonstrated by the financial impact of Silicon Valley Bank's collapse in March 2023. A report for the US Federal Reserve and Federal Deposit Insurance Corp concluded that the collapse of the bank was driven in large part by risk management and governance failings.[3] The bank's failure also sent ripples of fear around the globe that ultimately triggered the downfall of Credit Suisse, long beset by governance troubles.[4]

In our Q1 2019 Public Engagement Report,[5] we also identified corporate governance shortcomings at Vale following the collapse of an iron ore tailings dam near Brumadinho in Brazil, and highlighted that bondholders who failed to take account of ESG risks or engage with issuers, did so at their peril.

Since we published that article, there has been strong momentum in sustainable bond financing, with the green, social, sustainable, and sustainability-linked bond (GSSSB) market expanding from just over US$200bn in 2018 to $946bn in 2023, according to Moody's.[6] With this increased issuance, we are seeing greater regulatory scrutiny of issuers' sustainability strategies.

[1] We can all get along | Federated Hermes Limited (hermes-investment.com)
[2] We can all get along (part II) | Federated Hermes Limited (hermes-investment.com)
[3] Highlights from US regulators' reviews of SVB, Signature failures | Reuters
[4] What Happened at Credit Suisse, and Why Did It Collapse? (investopedia.com)
[5] Public-engagement-report-q1-2019.pdf (hermes-investment.com)

From January 2024, the EU Taxonomy requires investors to disclose the proportion of their underlying investments that are taxonomy-aligned, initially covering climate change mitigation and adaptation. And in 2023, the UK's Financial Conduct Authority (FCA) sought investor comment on a paper that proposed improvements in documentation and practices relating to use-of-proceeds and sustainability-linked bonds.[7]

In our response to the FCA, we supported greater disclosure, which we believe would improve transparency, providing investors with more complete and accurate information. It would also reduce the risk that bonds' real-world impacts differ from their stated purpose, which could otherwise lead to allegations of greenwashing.

We highlighted our view that the FCA's proposed disclosures would be conducive to the ongoing internal review and evaluation of issuers' sustainability goals. This would help to ensure that boards and management teams are appropriately mitigating environmental and/or social risks and capturing emerging opportunities in a manner that is in the best interests of all stakeholders.

The growing significance of sustainable bond finance and the accompanying regulatory scrutiny are creating greater awareness and acceptance of bondholder engagement.

Benefits of engaging across the capital structure

EOS makes it clear to companies that we engage the value of assets under advice for the equity and the bond holdings that we represent. Speaking on behalf of an increased asset base across multiple asset classes gives us greater leverage – a view echoed by the Institutional Investors Group on Climate Change (IIGCC) in its *Net Zero Bondholder Stewardship Guidance Toolkit*,[8] to which Federated Hermes Limited contributed. This recommends integrating bondholder stewardship into existing equity engagements and stewardship strategies as a first step towards increasing the effectiveness of bondholder stewardship.

There is a sound rationale for combining the two. Business strategy and capital allocation affect a company's ability to create value for shareholders and to service current or future debt. Improved governance and mitigated risks have the potential to create value for shareholders and bondholders alike, as well as management, employees and wider society.

Evolving our engagement approach

Credit and equity engagements focus on the same long-term ESG risks and opportunities. For example, when considering climate change and the associated risks and opportunities, there is rarely a need to differentiate between equity and bondholder interests. However, over the last few years we have been reflecting on how best to evolve our approach to credit engagement to ensure we consider the specific circumstances that exist for any given company.

One development has been to incorporate credit-related data into our research notes. This includes a figure for the bond refinancing due for a company in the coming 12 months, because

CASE STUDY

Enel

Italy's Enel is a generator and distributor of electricity and a distributor of natural gas. It generates power from renewable and non-renewable sources, operates power networks, and supplies energy to homes and businesses.

Enel is a significant issuer of Sustainability-Linked Bonds (SLBs) and was an early adopter of this structure with its first issuance in 2019. Over the course of 2021 and 2022 the company issued several sustainability-linked bonds, totalling $10.8bn, making use of a sustainability performance target for Scope 1 emissions intensity in 2023. If this target was not met, the bonds would be subject to a 0.25% step-up, potentially resulting in an annual increase of $27m to the company's interest payments.

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In our engagement with the company in 2023 it said that, while it remained confident about its ability to achieve longer-term emissions reduction targets, there was a reasonable chance that the 2023 target relevant for these SLBs would be missed. This would depend on the availability of water for hydropower generation and the price of natural gas, potentially resulting in higher coal-fired generation than expected. We continue to emphasise the importance of the company maintaining and delivering on its ambitious decarbonisation strategy, which will help to support the ongoing credibility of its SLB issuance.

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[6] Global sustainable bond issuance to reach US$950 billion in 2024: Moody's, ESG - THE BUSINESS TIMES
[7] Non-equity securities – Engagement Paper 4 | FCA
[8] IIGCC-Net-Zero-Stewardship-Guidance.pdf (hubspotusercontent-eu1.net)

an awareness of the timing and size of refinancings may provide an opportunity to intensify engagement. The aim is to speak to management when they may be most receptive to the messages we are conveying on behalf of our clients.

When we consider the potential levers for engagement, voting can be important. However, for tightly-controlled companies or state-owned enterprises, it is worth noting that the voting decisions of minority shareholders will have a minimal impact, whereas the refinancing of bond debt may be critical. In these circumstances, bondholders clearly have the potential to exert greater influence.

When it comes to issuing bonds, the approach taken by companies varies. At one end of the spectrum, investment grade issuers tend to consider refinancing regularly and proactively based on changing market rates and credit spreads. At the other end, while high-yield issuers can refinance their debt at any time, they are more likely to be receptive to investor expectations and engagement when they need to refinance a significant proportion of their debt.

For investment grade issuers, reminding management of the company's recurring presence in the capital markets may provide a constructive context for an engagement, while for a high-yield issuer, highlighting its reliance on a key refinancing event is likely to be more effective.

Ahead of engaging with a company, we may consider its credit rating and its credit default swap (CDS) spread - a measure of insuring against default on a company's debt. One might assume that engagement should be triggered by widening CDS spreads, declining credit ratings, or share price falls. However, we believe that in most cases engagement should be long term and ongoing rather than reactive. At the same time, we acknowledge that we may need to escalate engagement on the back of a certain event, which will impact bond and equity prices.

Who to engage

We may consider speaking to the CFO and company treasury department, rather than investor relations or a company's sustainability team, if we believe this would help to complement wider engagement with the board and senior executive team. At times, we will engage beyond the company level, in the broader credit ecosystem, if we believe that we can achieve greater impact by doing so.

We have also found that management teams have become more receptive to credit engagement on the whole. This is because the legitimacy of bondholders to engage on longer-term business strategy and sustainability has been strengthened by changing policy and market best practice. The issuance of bonds increasingly requires companies to go beyond the consideration of the short- and medium-term financial metrics, which may be the focus of a treasury team, and to articulate the strategy for ensuring the long-term sustainability of the business. There may also be opportunities for companies with well-planned, long-term sustainability strategies in place to secure advantageous rates of financing through green and sustainable bond issuance – an area which we intend to monitor and explore further.

CASE STUDY

Pemex

Petroleos Mexicanos (Pemex) is Mexico's 100% state-owned integrated oil company, operating through the business segments of exploration and production, industrial transformation, logistics, drilling and services, ethylene, fertilisers, cogeneration and services.

The company has a poor track record in terms of its accident rate, fuel theft causing environmental damage, corruption, and insufficient action to mitigate climate change. The excessive debt burden, underinvestment in safety and pipeline integrity, political interference and high turnover of executives deteriorates the performance and makes investor engagement challenging.

For example, in a July 2023 interaction with a board member as part of a Climate Action 100+ engagement, we expressed our concern about the deterioration of Pemex's safety performance. The board member said that although every accident is investigated and recommendations for improvement are made, a lack of financial resources impacted the safety performance. Pemex is the most indebted oil company, with approximately US$100bn in financial debt, predominantly in the international debt capital markets. The company relies on the bond markets with regular bond issuance to refinance its debt.

In our engagement with Pemex, we have emphasised that poor ESG performance increasingly feeds into the company's ability to access the international debt markets and a potentially higher cost of capital. Following elections in Mexico in 2024, a new government will be inaugurated in early 2025, and is likely to make changes to Pemex's board and management.

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Board Composition and Effectiveness

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