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The Greening Of The Corporate Bond Market

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The Greening Of The Corporate Bond Market

News of the successful issue of the largest-ever green bond by French power company GDF Suez last week is shining a spotlight on this emerging area of corporate finance. At €2.5 billion (US$3.4 billion), GDF Suez's issue represents close to a third of the total €7.6 billion ($10.4 billion) of corporate green issuance since November last year, and almost doubles the previous record of €1.4 billion ($1.9 billion) set by another French power company, Electricite de France. Standard & Poor's Ratings Services estimates that, based on year-on-year growth trends, the corporate green bond market in 2014 will be double the size of last year's total green bond issuance, at around $20 billion.

These mega deals show the rising importance of green bonds as a source of capital, driven by both the needs of corporates, as well as the desire by investors to allocate capital to socially responsible and environmentally sustainable investments. The aim for both issuers and investors alike is to develop a large and liquid market in order to reduce transaction and investment costs.

Overview

- The corporate green bond market, currently at $10.4 billion, is gathering convincing impetus and we estimate that, based on year-on-year growth trends, it will grow to around $20 billion globally, double the size of the total green market in 2013.
- In our view, corporate green bond issuance is accelerating not only because this aids diversification of investor pools for issuers, but also because of investors' growing interest in implementing environmental, social, and governance goals.
- So far, corporate green bonds have mostly been issued in Europe, generally with investment-grade ratings of 'A+' or 'A'.

Corporate issuers see green bonds as an alternative financing avenue, offering access to a diversified investor base, plus a means of implementing and maintaining efficiency measures considered environmentally sustainable. A key distinction of green bonds from mainstream corporate issuance is that proceeds are ring-fenced and allotted to finance or refinance projects addressing environmental issues. So far, investors have not shown any discrimination against corporate green bonds, with many issues to date being oversubscribed. Standard & Poor's believes this trend is likely to continue, as green issuance shifts away from multilateral development banks toward mainstream corporates. The future development of the green project bond market could also see the aggregation of environmental projects to form debt obligation instruments and an increased focus on the refinancing of existing environmental projects.

The Climate Bonds Initiative (CBI), a non-profit organization that promotes investments to combat climate change, predicts total green bond issuance from all sectors will reach $40.0 billion in 2014. However, based on the amount of green bond issuance so far this year, we think that half this figure could easily be reached by corporate issuance alone. Entry into this expanding market is enabling corporates to tap an additional pool of investors who are committed to principles of socially responsible investing. In our view, corporate issuance is likely to accelerate not only because this aids diversification of investor pools, but because of investors' growing intention to implement environmental, social, and governance (ESG) targets initiated by the United Nations Principles for Responsible Investment (PRI). As of April

2013, the 1,188 investors who had signed up for the PRI represented approximately $34.0 trillion of assets under management (AUM), which was over 2.5x the amount five years previously (see chart 1). In addition, the PRI has encouraged 30 stock exchanges to enhance ESG disclosures among their listed companies.

Green Bonds Explained

Crucially for investors, the credit risk of a corporate green bond remains on the issuer's balance sheet. This means that, unlike with multilateral bank issuance, investors do not have to sacrifice yield to gain green exposure, nor significantly increase their risk profile in order to invest in assets that aid environmental efforts. This can satisfy investors' requirements for yield, while safeguarding their reputation for socially responsible investing. Investors are also likely to examine an issuer's environmental track record and reporting standards alongside participation in such initiatives, increasing the need for rigorous disclosure in offerings. Investors in green bonds also want assurance that the proceeds are being used to enable environmentally sustainable outcomes. In addition to this, according to a recent report by Societe Generale, investors have raised concerns regarding the lack of verification of how the proceeds of green bonds are used (see Note 1). We therefore expect a revision to standards used for green bond issuance to boost investor confidence, including those governing the use of proceeds.

A group of financial institutions has created a set of green bond principles to enable issuers to categorize their bonds as "green." In all cases, the proceeds should be exclusively applied toward new or existing projects that promote climate and sustainability actions. There are currently four types:

- Green use of proceeds bond: with recourse to issuer;
- Green use of proceeds revenue bond: nonrecourse to issuer--credit exposure is to the pledged cash flows of revenue streams, fees, taxes, etc.;
- Green project bond: investor has direct exposure to the risk of the project with or without recourse to issuer; and
- Green securitized bond: collateralized by one or more projects, e.g., covered bonds or asset-backed securities.

Table 1

Credit Fundamentals Of Corporate Green Bonds

Company name	Industry group	Standard & Poor's credit rating	Amount issued ($)*	Maturity date	Coupon (%)	Issue price
Acciona SA	Engineering and Construction	NR	86,596,500	29/04/2024	5.550	100.000
Arise AB	Utilities	NR	167,087,000	25/04/2019	3.902	100.000
Electricite de France	Utilities	A+	1,899,840,000	27/04/2021	2.250	99.561
GDF Suez	Utilities	A	1,777,160,000	19/05/2026	2.375	98.494
GDF Suez	Utilities	A	1,640,450,000	19/05/2020	1.375	99.345
Iberdrola International BV	Utilities	BBB	1,036,770,000	24/10/2022	2.500	N/A
Regency Centers LP	Real Estate	NR	250,000,000	15/06/2024	3.750	99.482
Rikshem AB	Real Estate	NR	15,249,200	20/05/2016	1.149	100.000
Skanska Financial Services AB	Engineering and Construction	NR	130,886,000	08/04/2019	1.863	100.000

Table 1

Credit Fundamentals Of Corporate Green Bonds (cont.)						
Svenska Cellulosa AB SCA	Forest and Paper Products	A-	154,240,000	02/04/2019	1.596	100.000
Svenska Cellulosa AB SCA	Forest and Paper Products	A-	77,120,000	02/04/2019	2.500	100.000
Toyota	Automakers	AAA	560,000,000	15/08/2016	0.410	99.999
Toyota	Automakers	AAA	480,000,000	15/12/2017	0.670	99.982
Toyota	Automakers	AAA	165,250,000	17/06/2019	1.180	99.987
Toyota	Automakers	AA+	43,750,000	15/04/2020	0.000	N/A
Unibail-Rodamco SE	Real Estate	A	1,025,360,000	26/02/2024	2.500	98.723
Unilever PLC	Consumer Products	A+	414,200,000	19/12/2018	2.000	N/A
Vasakronan AB	Real Estate	NR	152,272,000	25/05/2016	1.315	100.000
Vasakronan AB	Real Estate	NR	152,158,000	24/10/2016	1.255	N/A
Vasakronan AB	Real Estate	NR	102,283,000	19/03/2019	1.604	N/A
Vasakronan AB	Real Estate	NR	55,075,600	19/03/2019	2.473	N/A
Vasakronan AB	Real Estate	NR	45,681,600	25/05/2016	1.774	100.000

*Exchange rate as of May 16, 2014. Source: Bloomberg Professional. N/A--Not applicable. NR--Not rated.

The Market Is Growing As Corporates Issue Billion-Dollar Deals

Corporate green bonds still make up a relatively small percentage of the total green bond market, at about 30%, and are dwarfed by the size of mainstream corporate bond issuance, which according to S&P Dow Jones Indices stood at $18 trillion as of April 2013. Nevertheless, despite facing issues of volume, liquidity, and regulatory monitoring, the corporate green bond market has gathered convincing impetus since late 2013, with a number of large transactions expanding the market to $10.4 billion. In November 2013, the first billion dollar issue arrived in the form of Electricite de France's (EDF) $1.9 billion 7.5-year green bond, which was twice oversubscribed. In terms of the mainstream green bond market this was significant, not just because of its size--this was the largest to date at that time--but because it was issued by a corporate entity with a rating of 'A'. Up to then, green bonds had mostly been issued by multilateral development banks with 'AAA' ratings.

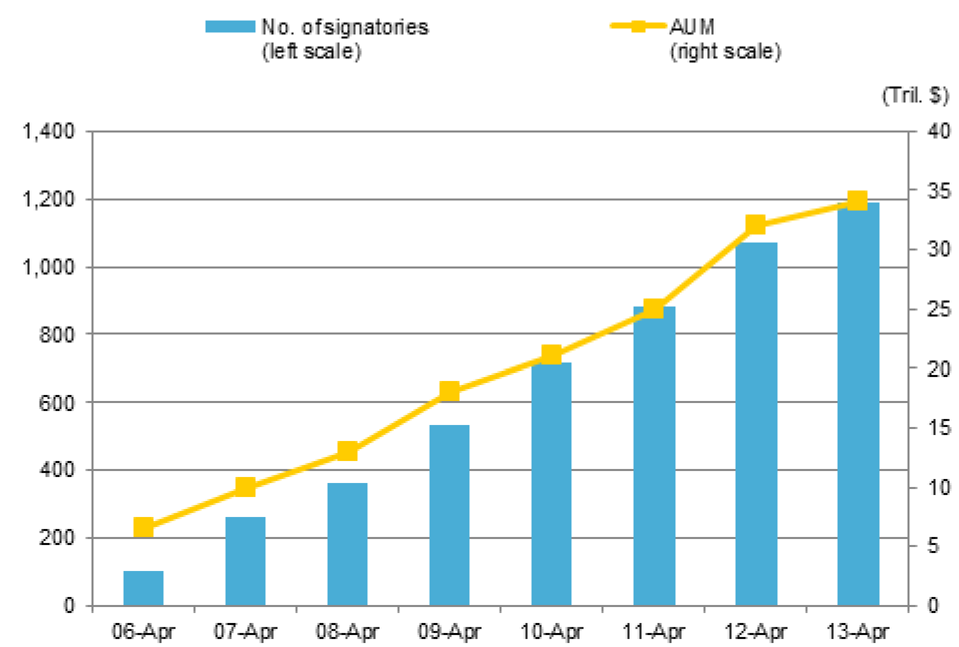
Next to break the $1 billion benchmark were Unibail-Rodamco SE with a $1.0 billion 10-year bond, and Iberdrola International BV with a $1.0 billion 8.5-year bond. Unibail's green bond was 3.4x oversubscribed and illustrated the real estate company's ability to diversify its sources of funding. It met investors' green requirements as its proceeds can only be used to finance building in compliance with the Building Research Establishment Environmental Assessment Method sustainability standard. Iberdrola's bonds, which will finance wind power and smart metering environmental projects, fared even better, being 4.0x oversubscribed despite only offering a 2.50% coupon, the lowest offered by the Spanish utility to date. Most of these green bonds are issued at par or discounted by less than 1.6% (see table 1). This month has seen the largest corporate green bond issuance so far, with GDF Suez's $3.4 billion dual-tranched green bond, comprised a six-year 1.375% coupon and a 12-year 2.375% coupon. Orders were 3.0x oversubscribed, evidence of the continuing strong demand for corporate green bonds, with approximately 65% of allocations coming from investors managing socially responsible investment funds. The proceeds for this deal will be used to fund renewable energy and energy efficiency projects.

Alongside these transactions, Unilever became the first fast-moving consumer goods company to issue a corporate green bond, the proceeds of which will be used for a wide variety of environmental projects globally, and are intended to aid diversification. Vasakronan, a Swedish property company, has also issued just under $1.3 billion of unrated corporate green bonds so far this year, in five smaller deals. Investors were 100% Swedish and almost all were pension funds.

While the corporate green bonds issued so far have been from well-known and higher-rated ESG names in the market, they could pave the way for other corporate entities. Furthermore, the bonds have been issued in Europe, backed by a gradually improving economic outlook. This may change if green bonds attract U.S. investors, who enjoy a larger source of liquidity in their domestic markets.

Chart 1

Growth Of Principles For Responsible Investment Initiative



AUM--Assets under management. Source: United Nations Principles for Responsible Investment (PRI).

Chart 2

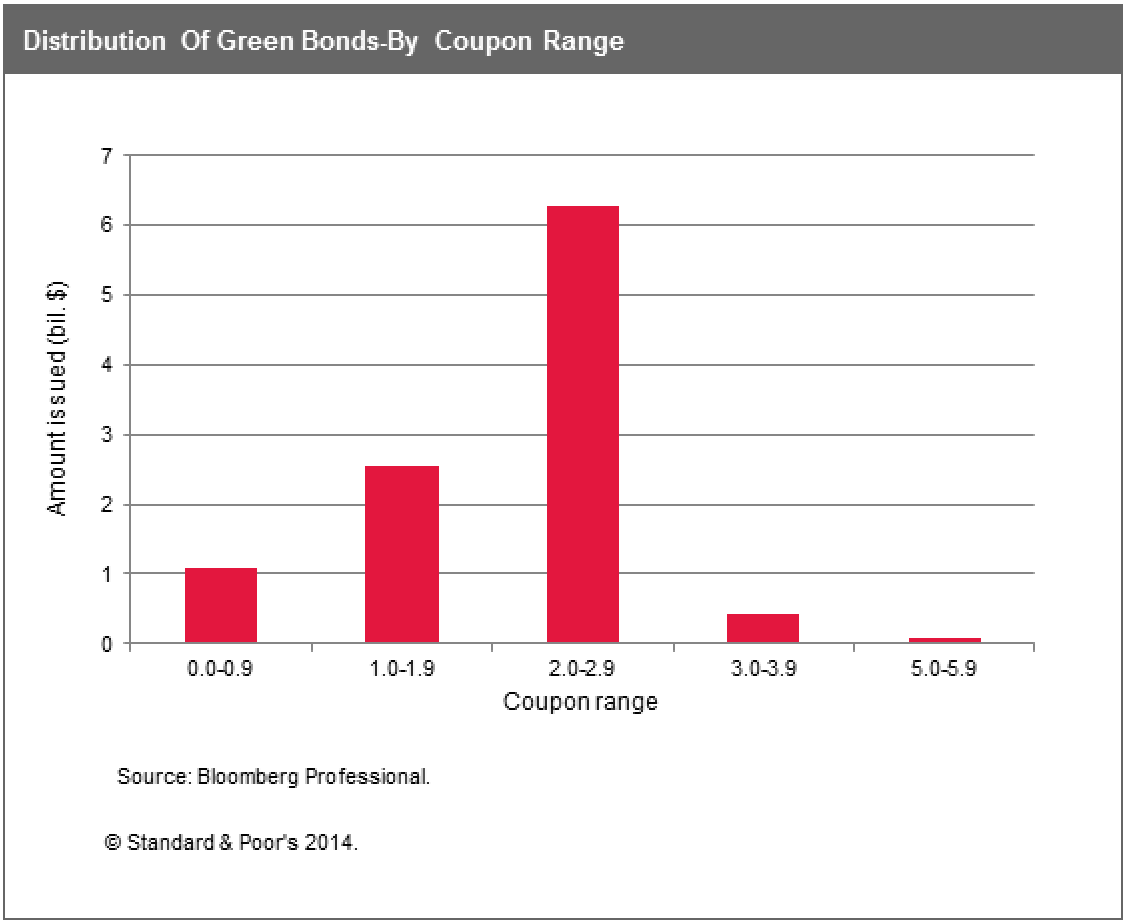

Distribution Of Green Bonds-By Coupon Range
7
6
5
4
3
2
1
0
Amount issued (bil. $)
0.0-0.9
1.0-1.9
2.0-2.9
3.0-3.9
5.0-5.9
Coupon range
Source: Bloomberg Professional.
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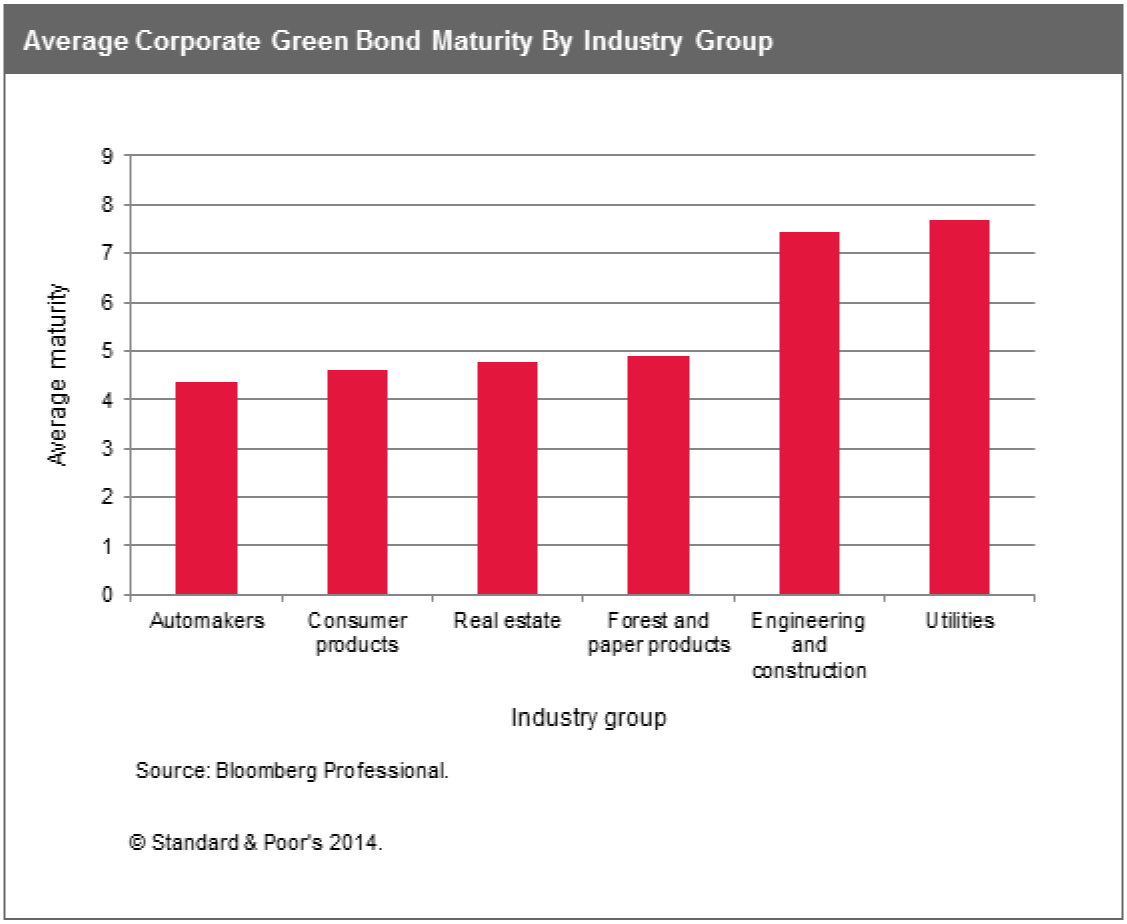
Chart 3



The Make-Up Of The Market

Coupons for corporate green bonds tend to be about 2.0%, with fixed rates for nearly all issuance ranging between 0.0% and 4.0%, and virtually none over 4.0% (see chart 2). This typically suggests that corporate green bonds are being marketed as low-to-moderate return investments. Such return characteristics are commensurate with their maturity profiles (see chart 3). Maturities are typically between four and eight years for all industry groups, making them medium-length investments. Automakers, consumer products and real estate, and forest and paper products are at the low end of spectrum with average maturities nearing four years, while engineering and construction and utilities are at the high end, heading toward maturities of eight years. Longer maturities increase their risk profiles, which is understandable, given that these industries have longer research and development timeframes and involve higher capital expenditure (capex) for construction.

Issuance to date has come from a number of industries, but has been led by utilities, which represent 62.5% (see chart 4). In part, this is because the two largest offerings to date were from EDF and GDF Suez, totaling $5.3 billion. In the future, we expect corporate green bonds could be issued by a variety of industry groups, and will likely be concentrated in industries that are considered lower-risk, are already experiencing good growth, and where upfront costs tend to be smaller.

Unlike multilateral development banks, which are mostly rated 'AAA', ratings for corporate green bond issuers are spread over the investment-grade spectrum from 'AAA' to 'BBB', with the majority at 'A+' or 'A' (see chart 5). We think this could boost confidence among prospective corporate issuers who are rated 'BBB-' or above, aiding market volume. In addition, European companies have issued a notable amount of unrated green bonds ($1.2 billion), including Vasakronan AB, Skanska Financial Services AB, and Arise AB. These have all achieved coupons under 4.0%, with the longest dated maturity being five years. In our view, this signals solid investor confidence, particularly in countries where these corporate entities operate, as demonstrated by 100% of Vasakronan's green bonds being bought by local investors.

Chart 4

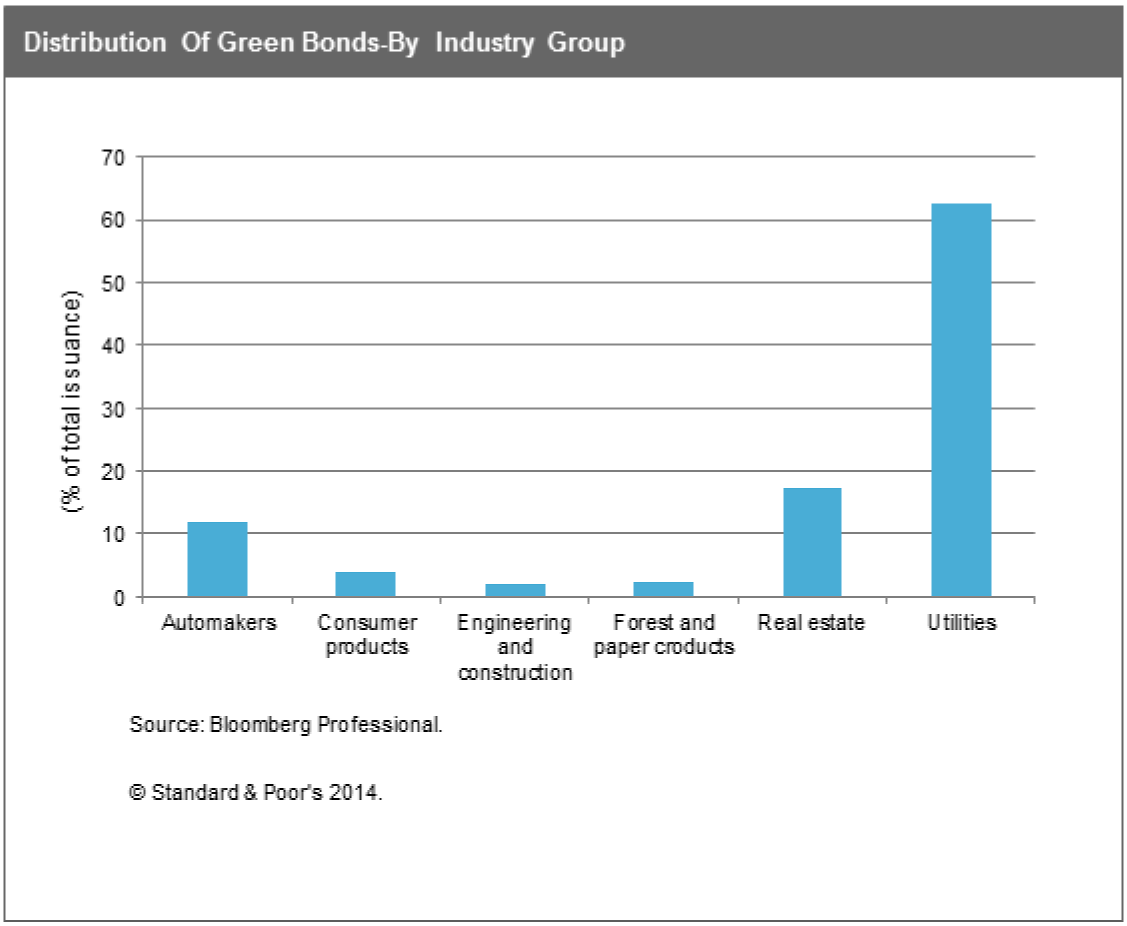
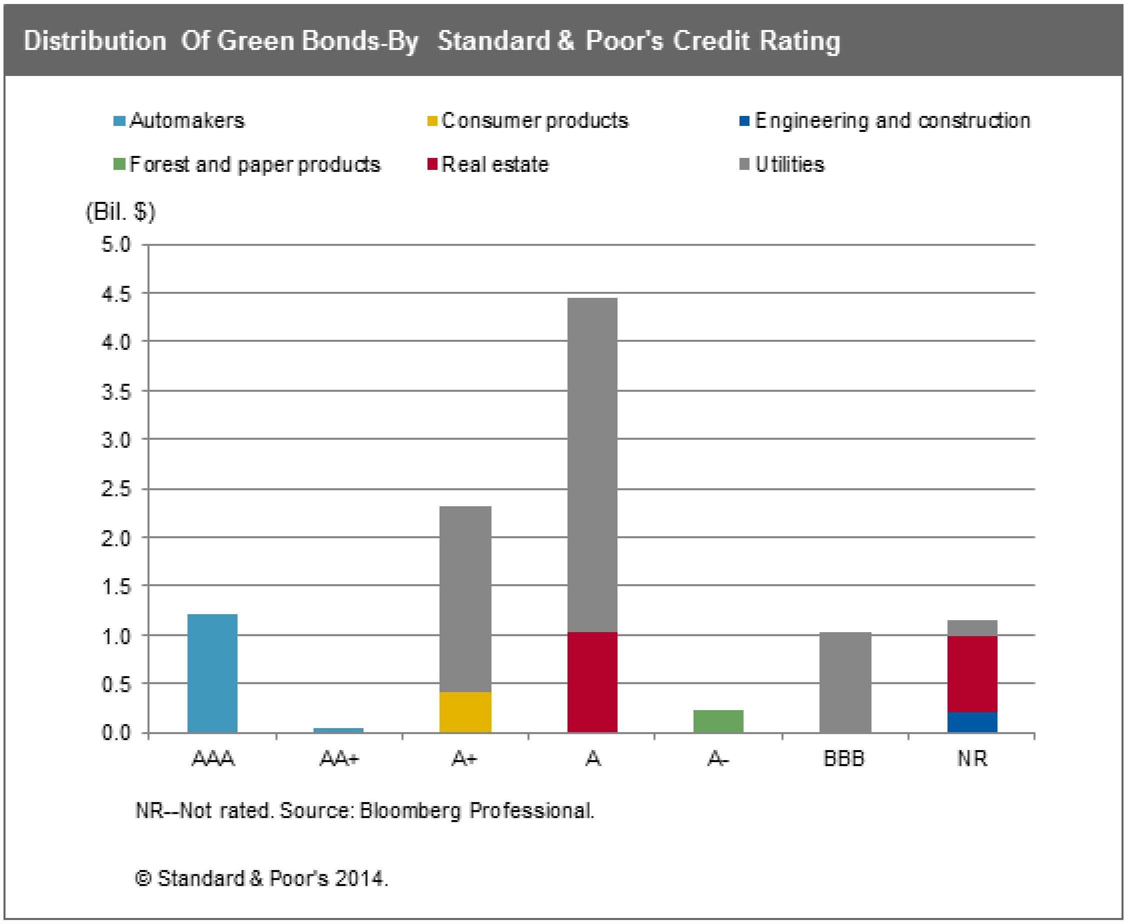


Chart 5



Future Prospects

In the current market, a lack of economies of scale are an obstacle to speculative-grade corporates interested in issuing green bonds, or higher-rated companies with smaller funding needs. As the market continues to develop, smaller environmental projects may be able to attract financing by aggregating into larger investment offerings. This could make them more suitable to larger investors.

We think it likely that the market will begin to see structuring of bonds to enhance credit support. We have already seen evidence of this from Toyota; it used securitizations of car loans to collateralize its corporate green bonds, which were quickly oversubscribed. Notably, the underlying collateral in these transactions was not considered "green," but the proceeds will still be allocated to fund green car development.

Furthermore, we think the next stage of market evolution will involve a shift in credit risk away from corporate entities, moving financing for environmental projects off their balance sheets. With corporate green bonds, the credit risk for the investor remains linked to the issuer's general corporate creditworthiness, with bond proceeds typically being earmarked for environmental purposes. Environment-related projects tend to have high upfront capex, low maintenance costs, and, if backed by government subsidies, relatively stable revenue streams. However, mainstream investors may not yet be willing to take on project finance style construction risk. In the short term, we expect this type of green bond will be related to the refinancing of existing projects or assets, since it tends to involve lower risk for investors. The second stage of growth may come in aggregation, where the risk to investors will be dependent of factors such as the type of environmental projects, how many projects are in the debt pool or portfolio, and whether construction has been completed. This method has the potential of increasing the overall credit rating on the portfolio for the combined projects, thus enhancing the likelihood of mainstream investor interest.

Notes

1. Credit Themes: Green Bonds – State of Play, Societe Generale Cross Asset Research, May 15, 2014

Related Criteria And Research

- Corporate Methodology, Nov. 19, 2013
- Capital Market Involvement Holds The Key To Clean Energy Financing, June 26, 2012
- Can Capital Markets Bridge The Climate Financing Gap? Oct. 4, 2010