Green bonds: Finding sustainability, finding value

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Rising demand for sustainable fixed income is being met by robust supply of green, or sustainable, bonds. But balancing sustainability and value requires careful assessment of each opportunity on its own merits.

A BROADENING OPPORTUNITY SET

Demand is growing for investments that have the potential both to do well and do good – not only in equity markets, but across the board. Sustainable fixed income globally saw EUR 59 billion of inflows in 2020, representing a 39% increase vs 2019[1].

The same trends that are driving demand are also boosting supply. As investors, companies, regulators and governments rapidly align behind the goals of the Paris Agreement, issuance of green, social and sustainable bonds is soaring, from USD 565 billion in 2019 to USD 732 billion in 2020.[2] What has previously been a European-dominated market is now broadening out, with the US dollar looking set to become the primary currency for sustainable financing in 2021, at the current pace. Beyond the developed world, sustainable issuance from both sovereigns and corporates in emerging markets is also growing.

On a sector basis, too, the market is becoming increasingly varied, with issuance no longer confined to industries under particular scrutiny for the sustainability of their practices. Recent issuance has come from a wide range of sectors, led by utilities, banks, REITs and technology. Some companies, particularly utilities, have gone further, stating that they are unlikely to ever issue another 'non-green' bond since all of their financing will be linked to sustainable programmes.

Companies are issuing sustainable bonds for a wide range of purposes, from banks funding construction, refurbishment and/or preservation of affordable housing in low-income communities to auto companies funding research and development for electric vehicles. Government issuers have raised funds for the transition to a lower-carbon economy, to support climate resilience, and for investment in science, technology and public education.

BALANCING SUSTAINABILITY AND VALUE

For investors in this growing part of the bond market, there are two key questions: how to assess sustainability, and how to assess value.

Some companies embed sustainability into bond covenants. For example, in the utilities sector, Italian gas and electricity provider Enel has committed to a step-up coupon programme linked explicitly to sustainability targets. For one recent sterling issuance of a seven-year bond linked to the UN Sustainable Development Goals, if the company does not achieve its installed renewable energy capacity target of 60% by the end of 2022, the coupon increases by 25 basis points (bps).

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[1] Source: Morningstar, 2019 - 2020
[2] Source: BloombergNEF, January 2021.

The utilities sector was one of the earliest issuers of green bonds, and best practices around accountability are becoming established, with most companies making similar commitments based on energy transition goals. In sectors where ESG initiatives align less clearly with the objectives of the sector, evaluating sustainability can be more challenging. We believe that the next stage of development for ESG-linked bonds will be more independent oversight, similar to that provided by credit rating agencies, to ensure companies are held accountable.

When it comes to assessing value, active investors need to evaluate each sustainable bond on its own merit, as they do with traditional bonds. For us, that means looking at fundamentals, technical factors and quantitative valuations. Many sustainable bonds tick the fundamental box, and we have already discussed the positive technical factors for the sector, with investor demand growing. However, some fall short on valuations.

It is reasonable to expect a green or sustainable bond to yield slightly less than its non-green counterpart. But today, with index spreads so tight, the challenge is that 'slightly less' is a significant discount. With less room for spreads to compress, every basis point of yield counts.

So how to identify value? Consider the following examples,[3] using two green bonds issued in 2020.

- **Verizon,** a US telecoms company, came to the US dollar market with a 10-year green bond in September 2020. The company has reasonable fundamentals, and management has a demonstrated commitment to sustainability. The deal was announced with initial pricing expectations of 110 bps in spread (secondary bonds were trading around 90-95 bps at the time, so 110 bps would have represented an attractive new issue premium). For context, the same company had priced a non-green 10-year bond in March, at the height of Covid-19 volatility, at 225 bps. In the September issuance, the green deal actually priced at 83 bps, significantly less than initial price thoughts: not only below the company's existing bond with a similar maturity, but importantly, offering limited upside given outright spread levels. As a result, the valuation did not look attractive.
- **Excel Energy Inc.,** a US utility, came to market in June 2020 with a green bond priced at 105 bps. We believe the company has a solid fundamental outlook, and it tends to score particularly highly from an ESG perspective due to its commitment to transition towards renewables. We felt that the deal, pricing as it did, had scope to outperform other outstanding 30-year secured bonds of peers, because of the company's favourable ESG credentials in this part of the capital structure. Subsequently, this did come to pass as the bond outperformed during the late 2020 rally.

As these examples show, a clear commitment to sustainable business practices is commendable, but total return investors also need to scrutinise valuations. Investors need to evaluate where green bonds are pricing in relation to non-green bonds, and evaluate fundamentals and the risk-return profile accordingly.

BEYOND GREEN BONDS

Of course, sustainable bond investing does not need to be confined to bonds labelled as 'green' or 'sustainable'. Improved disclosure from companies around ESG considerations – from climate risk to diversity – is supporting more informed investment decisions across the board. By looking at the whole market, traditional as well as green bonds, through the lens of sustainability, fund managers are able to construct sustainable portfolios from a wide range of types of debt.

Evidence suggests that considering sustainability as part of the investment decision does pay off in performance. More than 89% of studies find that ESG strategies generate better risk-adjusted returns over the long run. And in the extreme volatility of early 2020, sustainable funds markedly outperformed the competition. With sustainable fixed income funds allowing investors to align the goals of doing well and doing good, we expect demand – and issuance to meet that demand – to continue to grow.

[3] These securities are shown for illustrative purposes only. Their inclusion should not be interpreted as a recommendation to buy or sell.

NEXT STEPS

For more information, contact your J.P. Morgan representative.

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