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WHITEPAPER

# Looking beyond the ESG self-label

## Acuity's scorecard for identifying best-in-class sustainability-linked bonds

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# ESG due diligence pays off: investors should be alert to "sustainability washing"

The recent proliferation of self-labelled ESG debt instruments has created an increasingly complex investment landscape for fixed income asset managers to navigate, leaving them vulnerable to "sustainability washing" by unethical credit issuers.

This is especially a concern for the newcomer to the sustainable-debt universe, sustainability-linked bonds (SLBs). This new generation of ESG-labelled bonds has been touted as having the potential to take fixed income ESG investing mainstream, by providing investor engagement opportunities previously limited to equity investors through proxy voting. However, at the same time, this rising star of sustainable debt is extremely vulnerable to "sustainability washing", given a lack of compulsory market standards or enforceable regulations for issuers, as well as the flexibility afforded to issuers to set their own key performance indicators (KPIs)/sustainability performance targets (SPTs), which are often unambitious or exclude a large share of their carbon footprint. Issuers also set their own coupon step-up penalties, which set in if SPTs are not achieved, creating another avenue to manipulate structural loopholes such as setting low coupon step-ups or step-ups that kick in after the bond's call date.

Investors should, therefore, be picky in the coming year and conduct ample due diligence on SLBs prior to investing. Acuity Knowledge Partners' (Acuity's) experienced credit research team has designed an SLB rating system that looks beyond the ESG self-label and market hype/oversubscription of SLB issuances. Our proprietary scorecard is designed around three pillars, in line with the three main areas of investor concern, namely (1) ambitiousness of targets, (2) cost of failure and (3) transparency and integrity of reporting.

Our rating mechanism has been tested on our in-house SLB database of more than 100 issuances covering corporates, sovereigns and municipal issuers, across multiple geographies, credit ratings and tenors. Clients can also opt to access our database as a starting point for SLB selection, as it allows for custom portfolio creation through a dynamic dashboard that filters issuance by region, sector, credit rating, currency denomination, year of maturity, callability and SLB tier rating.

## Key features and benefits of Acuity's SLB ratings framework and database:

- **A standardised SLB database** of more than 100 issuances covering corporates, sovereigns and municipal issuers is available for testing. It allows for custom portfolio creation through a dynamic dashboard that filters issuance by region, sector, credit rating, currency denomination, year of maturity, callability and SLB tier rating. Data extraction for the database is supported by Acuity's proprietary suite of Business Excellence and Automation Tools (BEAT) that conduct an artificial intelligence (AI)-driven search of company documents.

- **A five-tier rating scale,** ranging from "outstanding" to "poor", derived from 16 qualitative and quantitative scoring criteria, grouped under three pillars representing the main areas of investor concern: (1) ambitiousness of targets, (2) cost of failure and (3) transparency and integrity of reporting.

- **Dynamic pillar weights,** offering clients the option to select Acuity's default setting, select equal pillar weighting or overweight the pillar that matters most to them.

- **Penalises unethical issuers** setting coupon step-up penalty dates after an SLB's call date.

- **A coupon step-up trigger alert** which serves as an early warning to clients on issuances that are unlikely to achieve their SPTs by the stipulated time frame. Bondholders concerned about benefiting monetarily from an issuer's climate failure or social crisis could, therefore, choose to divest such SLBs in advance of the coupon step-up kicking in, or even proactively engage with issuers and pressure them to meet targets. **Our product successfully predicted recent trigger events such as Public Power Corporation's (PPC's) failure to meet its end-2022 SPT and Chanel missing its interim renewable energy target for 2021.**

- **UN SDGs** targeted by SLBs are highlighted. Alignment with SDGs, despite not being mandatory when setting SPTs, indicates an issuer's objectives in terms of sustainable financing and enables investors to filter issuances based on their internal SDG mandates.

- **Insightful analytics and visualisations,** including (1) a dynamic gauge chart that shows, on average, how much of a particular SPT was achieved at the time of SLB issuance – the lower the achievement at the time of issuance, the more ambitious the target, (2) a spider-web chart that provides a snapshot of each issuer's score on each of our 16 criteria, (4) UN SDGs addressed by KPIs and (5) a bubble chart showing performance against the three scoring pillars.

- **Eases the burden of high-volume, time-consuming work:** Asset managers tasked with evaluating detailed documents, including SLB frameworks, second-party opinion reports and annual progress reports, for hundreds of SLBs get access to Acuity's readily deployable SLB scoring system and database. Acuity will use its proprietary AI-/machine learning (ML)-based technologies for fast data extraction and web scraping to optimise efficiency. Our scorecard then contextualises and converts the data into useful and processable information.

## Separating the winners from the losers: five reasons investors need a robust SLB scoring framework

### 1. Immaterial financial penalties* for missed targets

**>50%**

of the SLBs in Acuity's database have a coupon step-up penalty of only 25bps

**A low-coupon step-up relative to the overall SLB coupon – too small to incentivise issuers to meet their pre-determined SPTs within the stipulated time frame*

### 2. Manipulation of structural loopholes

**~25%**

of the SLBs in Acuity's database have a call date before their coupon step-up date

### 3. Missed targets

Coupon trigger events likely in **~60%** of SLBs in our database

### 4. Unambitious* targets

**41%** of SLBs in Acuity's database had achieved >50% of their SPTs at the time of issuance

The prevalence of such unambitious targets remains a major concern for impact investors

** ESG targets that are 1) not quantifiable, 2) mostly achieved at the time of issuance, 3) not linked to issuer's core business, or 4) not benchmarked against standards (ex: SBTi)*

### 5. Irrelevant KPIs

**~8%**

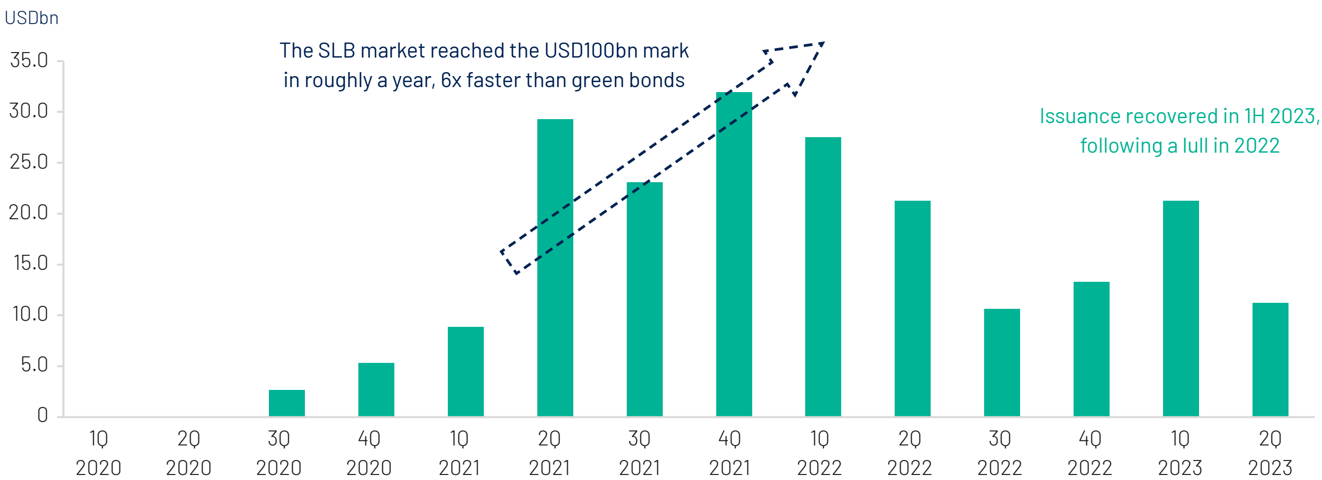
of issuers in Acuity's database had KPIs neither core nor secondary to their business

## SLBs: rising star or problem child of the sustainable-debt universe?

### Initial hype: the SLB market reached the USD100bn threshold 6x faster than green bonds amid sky-rocketing popularity

SLBs grew exponentially after the launch of the first SLB by Enel in September 2019, with the market reaching the USD100bn mark in 2021, roughly 6x faster than green bonds. In this initial honeymoon phase, each new issuance was celebrated by ESG investors and heavily oversubscribed, offering an opportunity to issuers (particularly from carbon-intensive sectors) that were previously unable to participate in the sustainable-debt market to signal their energy transition/decarbonisation objectives and commitment to sustainability improvement while raising cheaper financing. The instrument remained popular in 1H 2022, with new issuance up c.28% y/y – the only bright spot in the sustainable-debt universe amid a slump in overall green, social, sustainability and sustainability-linked (GSSS) debt, with new issuance falling by c.14% y/y during the same period. However, SLB issuance volumes declined (-57.5% y/y) in 2H 2022 amid a challenging market landscape for fixed income markets in general, and the decline continued into 1H 2023 (-33.3% y/y), in contrast to a recovery in the rest of the GSSS market, amid investor concerns about sustainability washing.

**Strong investor appetite supported significant growth in SLB issuance volumes from 2021 to 1H 2022**



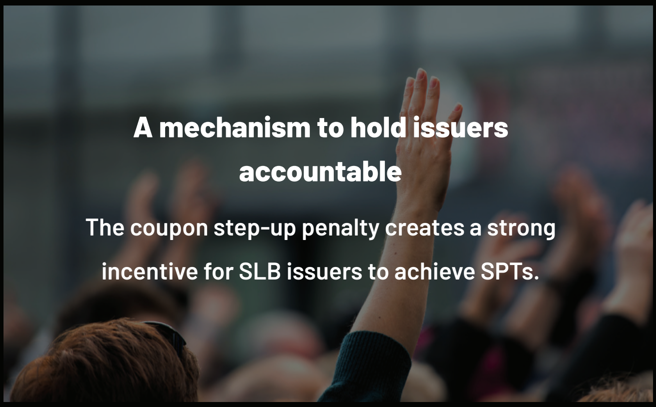

Source: Moody's Investors Service (2023)

## Issuer engagement: SLBs can revolutionise the role played by debt financing in the transition to net zero

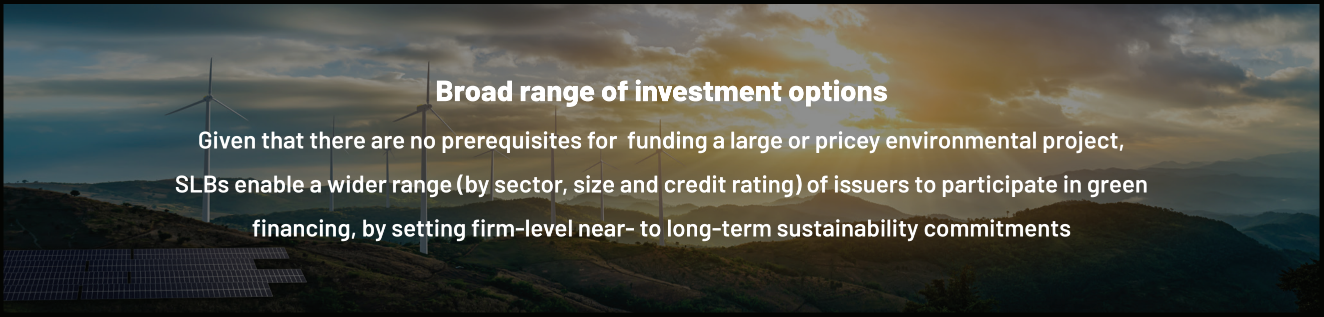
The structure of an SLB is straightforward: it is a performance-based instrument, with a coupon linked to pre-defined SPTs that are calibrated to environmental or social KPIs. If the issuer fails to achieve its SPTs by the stipulated time frame, it incurs a penalty, generally in the form of a coupon step-up. In contrast to use-of-proceeds bonds (green, social and sustainability bonds), where funds raised finance/refinance specific projects, proceeds from SLBs can be used for any purpose. This flexibility has boosted their popularity with issuers, as it renders them suitable for a wide range of sectors (including healthcare, fashion, FMCG, industrials, materials and mining), whereas green bond issuance has thus far been from a limited range of sectors due to the requirement for a large or pricey green-eligible project.

From a fixed income ESG investor perspective, the main appeal of SLBs is, in our view, their potential to revolutionise the role that debt financing can play in driving emission reduction and effecting positive social change. Debt financing accounts for c.90% of new capital raised by fossil fuel companies, according to the World Economic Forum. However, without equity voting powers, avenues for bond investors to actively engage with issuers and pressure them to set ambitious climate-change/net-zero targets are limited. **SLBs encapsulate clearly measurable, firm-/corporate-level sustainability objectives** and, therefore, require an issuer to commit its full business to achieving a sustainability target, in contrast to **project-specific use-of-proceeds bonds where issuers are not obligated to meet company-level environmental or social goals.** Moreover, SLBs have predefined financial penalties for failing to meet targets. Fixed income investors can, therefore, actively participate in the clean-energy transition by selecting SLB issuers whose corporate-level sustainability priorities are aligned to theirs and hold them accountable for failure to meet targets through engagement, financial penalties and divestment.

### SLBs appeal to fixed income ESG investors for a number of reasons







## Tough love: investors need to be discerning in SLB selection to avoid 'sustainability washing'

Unfortunately, the very flexibility of SLBs that makes them appealing also makes them vulnerable to "greenwashing" or "sustainability washing" by unethical issuers looking to raise cheap financing without making a serious commitment to sustainability improvement. This has caused SLBs to fall out of favour with some investors who find it challenging to distinguish between worthy SLBs and issuances with debatable sustainability credentials. While credibility concerns are largely centred around three pain points, namely (1) the robustness of KPIs and SPTs, (2) the magnitude of financial penalties in the event of non-achievement of SPTs and (3) post-issuance reporting and verification, there are many subtle nuances and structural loopholes that investors need to consider within these three broader categories.

> **"SLBs could be one of the most effective instruments for driving change but at the moment there's an awful lot of greenwashing and confusion"**
>
> \- Ben Caldecott, Director of the Oxford Sustainable Finance Group, University of Oxford

For instance, for callable high-yield bonds, issuers can set the first call date of an SLB prior to the SPT measurement date, thereby effectively avoiding any penalty in the event of failing to meet an SPT by calling the bond. Other grey areas include the exclusion of Scope 3 emissions KPIs, the use of intensity ratios vs absolute emissions targets and setting SPT measurement dates close to a bond's maturity date (thereby minimising the impact of a coupon step-up on the issuer in the event of failing to meet targets). This underscores the need for heightened investor scrutiny and due diligence when selecting SLBs.

# Acuity's SLB rating product: a three-pillar, nuanced scoring system

## Introduction

We concur with investors that debatable practices of certain SLB issuers pose challenges in distinguishing between issuers abusing the instrument for their gain and issuers genuinely committed to improving their carbon footprint or social goals. However, this could be addressed through the use of robust SLB rating structures, such as Acuity's proprietary scoring product, which can flag subpar SLB issuance with poor sustainability credentials.

Acuity's experienced credit research team has designed an SLB rating system that looks beyond the ESG self-label and market hype/oversubscription of SLB issuance. Our proprietary scorecard is designed around three pillars in line with the three main areas of investor concern, namely (1) ambitiousness of targets, (2) cost of failure and (3) transparency and integrity in reporting. Each pillar comprises several sub-criteria, 16 in total, weighted by importance, to minimise subjectivity in the rating process. SLBs are assigned an overall rating, using a five-tier rating scale ranging from "outstanding" to "poor", as well as a rating on individual pillars.

Our rating mechanism has been tested extensively on our in-house SLB database of more than 100 issuances of corporates, sovereigns and municipal issuers, across multiple geographies, credit ratings and tenors. Clients can also opt to access our database as a starting point for SLB selection, as it allows for custom portfolio creation through a dynamic dashboard that filters issuance by region, sector, credit rating, currency denomination, year of maturity, callability and SLB tier rating.

## Key features and benefits

**Dynamic pillar weights:** Pillar weights are dynamic, offering clients the option to select Acuity's default setting or overweight the pillar that matters most to them.

**A coupon step-up trigger alert:** This serves as an early warning to clients about issuances that are unlikely to achieve their SPTs by the stipulated time frame. Bondholders concerned about benefiting monetarily from an issuer's climate failure or social crisis could, therefore, choose to divest such SLBs in advance of the coupon step-up kicking in, or even proactively engage with issuers and pressure them to meet targets. **Our product successfully predicted recent trigger events such as Public Power Corporation's (PPC's) failure to meet its end-2022 SPT and Chanel missing its interim renewable energy target for 2021.**

**Insightful analytics and visualisations** including (1) a dynamic gauge chart that shows, on average, how much of a particular SPT was achieved at the time the SLB was issued – the lower the achievement, the more ambitious the target, (2) a spider-web chart providing a snapshot of each issuer's score on each of our 16 criteria, (4) the UN SDGs addressed by the KPI and (5) a bubble chart showing performance against the three scoring pillars.

**Provides a standardised approach:** Enables comparison of SLBs across credit ratings, sectors and geographies, and factors in complexities such as callability provisions, creating a single snapshot of risks and opportunities.

**Eases the burden of high-volume, time-consuming work:** Asset managers tasked with evaluating detailed documents, including SLB frameworks, second-party opinion reports and annual progress reports, for hundreds of SLBs get access to Acuity's readily deployable SLB scoring system and database. Acuity will use its proprietary AI-/ML-based technologies for fast data extraction and web scraping to optimise efficiency. Our scorecard then contextualises and converts the data into useful and processable information.

## All-in-one snapshot: a sample scorecard generated by Acuity's framework

### Sustainability-Linked Bonds Scorecard

*a product of Acuity Knowledge Partners*

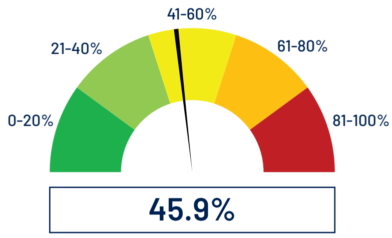
| ISIN | FR001400D0F9 | Issuer | Carrefour |
|---|---|---|---|

Bond Characteristics

| | | | |
|---|---|---|---|
| Issuer Type | Corporate | Currency | EUR |
| Industry | Consumer | Coupon (%) | 4.125 |
| Region | DM | Coupon Step Up (%) | n/a |
| Country of Domicile | France | Year of Issuance | 2022 |
| Credit Quality | IG | Year of Maturity | 2028 |

UN Sustainable Development Goals covered by KPIs


KPI achievement at issuance




Will the Coupon Step Up/Penalty Trigger?

**Yes**

Eligible as ECB Collateral?

**No**

### Overall SLB Rating

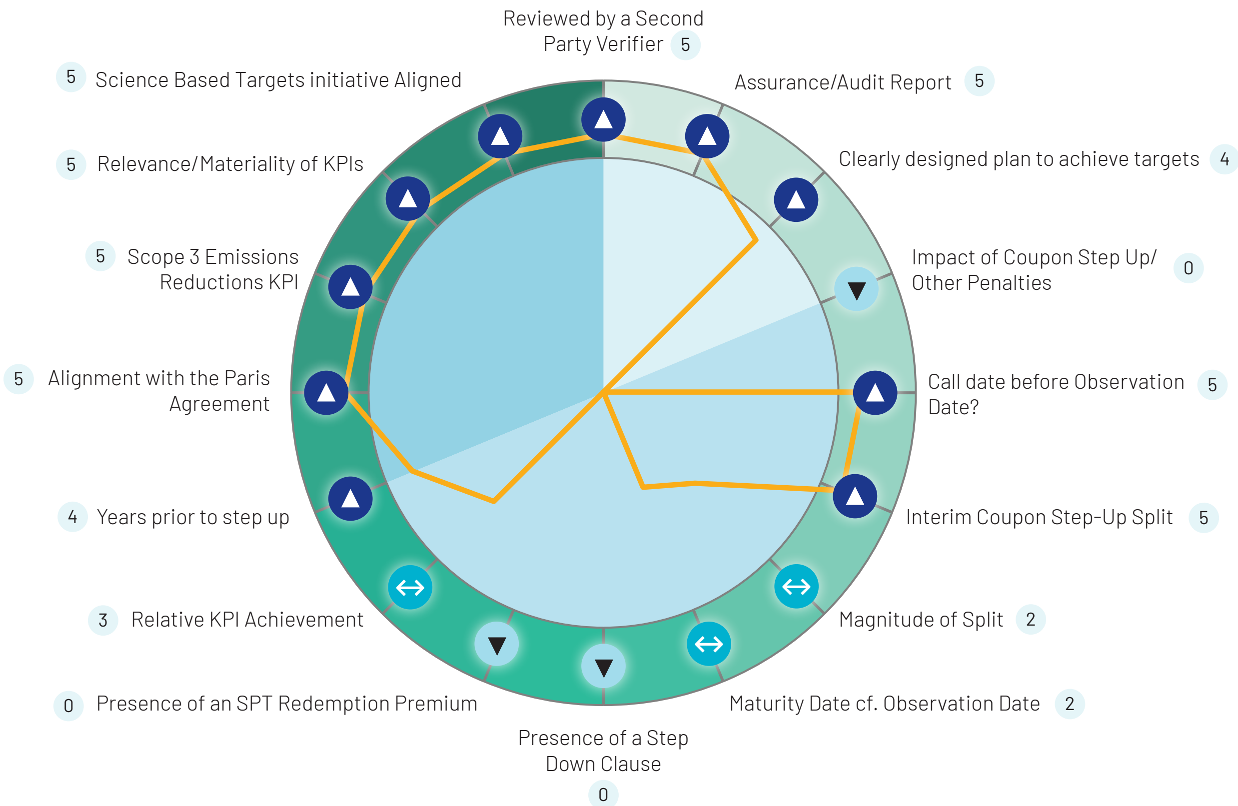
## 3.7 Outstanding

| Poor | Marginal | Fair | Good | Outstanding |
|---|---|---|---|---|
| 0.0 to <2.0 | 2.2 to <2.5 | 2.5 to <3.0 | 3.0 to <3.5 | 3.5 to <5.0 |

**Pillar Scores**

| Transparency and Integrity | Cost of Failure | Ambitiousness of Targets |
|---|---|---|
| 4.7 | 2.3 | 4.6 |
| Outstanding | Marginal | Outstanding |

**ESG Track Record** Good Bad



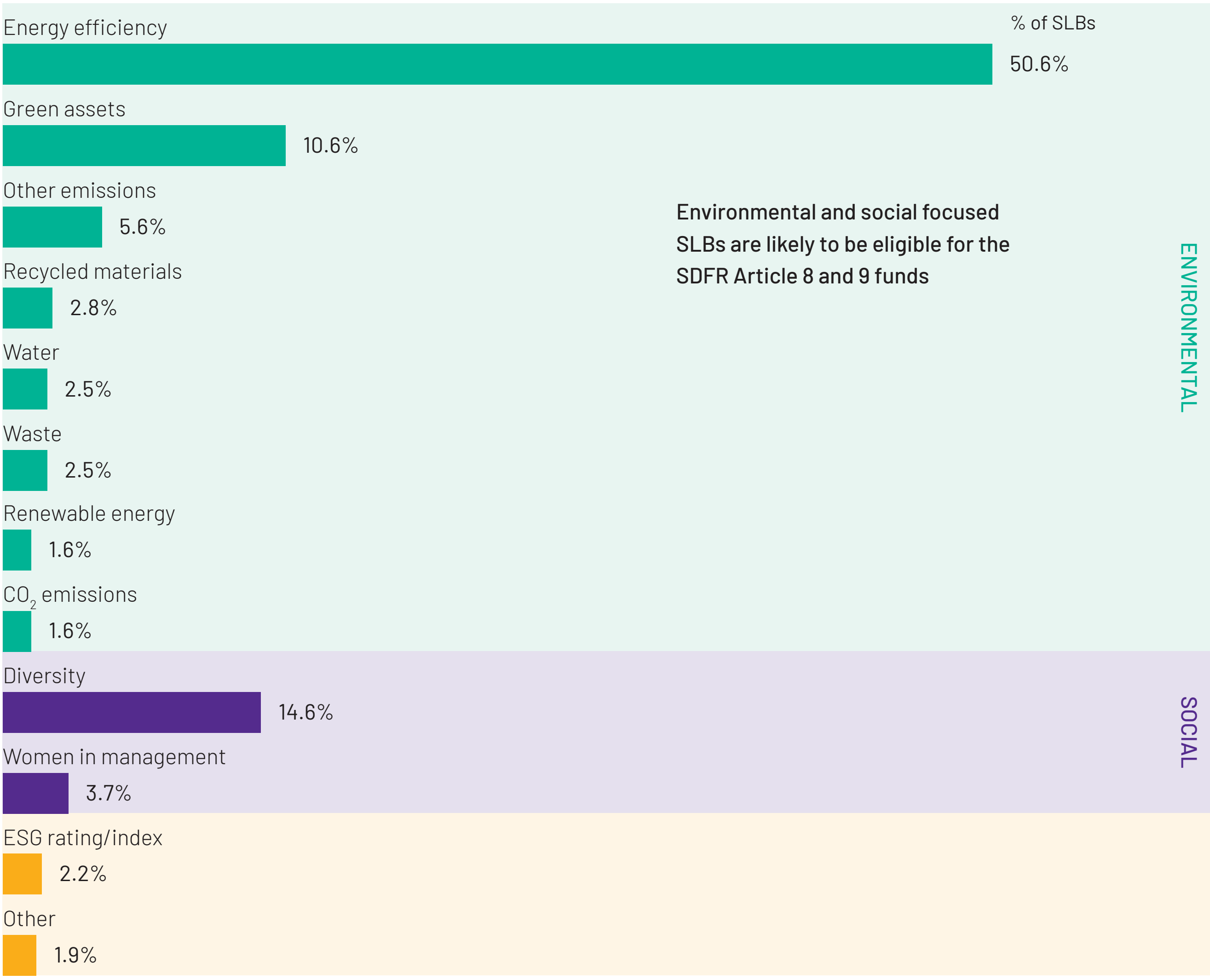

▲ Score above 3 ↔ Score between 1 and 3 ▼ Score below or equal to 1

# ‘Ambitiousness of targets’: scoring KPI selection and SPT calibration

## SLB issuers could engage in greenwashing by setting easily achievable SPTs or selecting irrelevant KPIs

As a starting point for conducting due diligence on an SLB issuance, we recommend that ESG investors assess the robustness and ambitiousness of its SPTs as well as the credibility and relevance of the KPIs to which the SPTs are calibrated. Environmental KPIs, particularly greenhouse gas (GHG) emissions, remain the most popular choice of KPI for issuers, with SPTs often being benchmarked to international targets such as the Paris Agreement, selected UN SDGs or the EU Taxonomy. Such SLBs have more broad-based investor appeal, as they are eligible collateral for both the European Central Bank (ECB) and Article 8 and 9 funds under Sustainable Finance Disclosure Regulation (SFDR), in contrast to SLBs with SPTs such as an improvement in an ESG rating. However, given that SLB issuers have the flexibility to set their own KPIs and SPTs, this leaves the instrument vulnerable to greenwashing through the use of unambitious and easily achievable SPTs and immaterial KPIs. Given that there are no restrictions on the use of proceeds from SLBs, KPI and SPT quality are key to ensuring meaningful issuer participation in sustainable activities. Consequently, prior to investing, not only the issuer’s repayment ability, but also the robustness of its ESG credentials in terms of KPI and SPT selection needs to be analysed rigorously.

Environment-linked KPIs remain the most popular choice for SLB issuers




Source: The World Bank (31 December 2021)

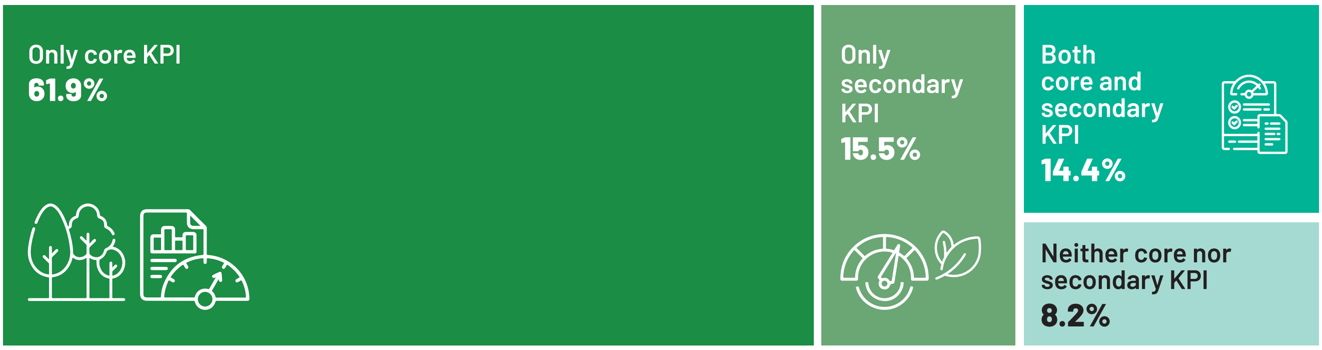
| KPI and SPT investor checklist | |
|---|---|
| **KPI requirements** | **SPT requirements** |
| » Material, relevant and of high significance to the issuer's core business<br>» Scientifically sound (aligned with net zero/a 1.5- to 2- degree Celsius global warming scenario) and covering Scope 3 emissions<br>» Quantifiable or measurable on a consistent basis<br>» Able to be benchmarked to peers or international standards<br>» Externally verifiable | » Should be ambitious and reflect a material improvement in KPIs with an SPT trajectory that goes beyond a "business-as-usual" scenario<br>» Should have a clear timeline for achievement<br>» If emissions-based, should target absolute reductions rather than an emissions intensity ratio<br>» Should be benchmarked to the issuer's historical performance and, if possible, peers and international targets |

Source: ICMA, Acuity Knowledge Partners

» **Meaningful KPIs:** Due diligence on the materiality of KPIs set by SLB issuers is key to preventing greenwashing. An example of poor KPI selection would be a financial institution setting itself a target of reducing Scope 1 emissions. Since the company is not engaged in manufacturing, its direct/Scope 1 emissions would constitute only a small part of its total emissions, and any targeted reduction would be both easily achievable and not meaningful. Our "Relevance/Materiality of KPI" scoring criterion, aligned to the International Capital Market Association's (ICMA's) registry of roughly 300 KPIs with recommended core and secondary KPIs for each sector, has flagged several such issuances in Acuity's in-house SLB database with KPIs that are not meaningful to the issuers' core business.

» **Robust and ambitious targets:** Some SLB issuers may select KPIs that are meaningful to their core business but set soft targets (SPTs) that are easily achievable or, in some cases, have already been largely met at the time of issuance. UK grocery store retailer Tesco, for instance, was criticised in 2021 for issuing one SLB with a modest target covering less than 2% of its annual emissions and another SLB linked to an emissions goal that had largely been achieved. While it is important for issuers to set targets that are feasible and realistically achievable over the SLB's lifetime, these targets must also, in our view, represent a tangible social or environmental improvement to warrant the reduced borrowing costs garnered by SLB issuances over vanilla bonds of the same issuer. As such, our scoring pillar goes a step beyond merely assessing an issuance on the ambitiousness of its own target trajectory by comparing its alignment to international targets such as the Paris Climate Accord.

About 8.2% of the issuers in Acuity's SLB database had KPIs that are neither core nor secondary to their business




*Around 10.3% of SLBs in Acuity's database had set targets that complied only partially with either a core or secondary KPI*

Source: ICMA, Acuity Knowledge Partners

## Acuity's AoT scoring pillar identifies sustainability champions with ambitious targets and meaningful KPIs

While issuers can, and do, get away with the bare minimum in terms of KPI/SPT selection, we have found these instances to be outliers rather than the norm. This is underscored by the fact that over 50% of the issuances in Acuity's in-house SLB database are rated "good" or "outstanding" under the "ambitiousness of targets" (AoT) scoring pillar that encompasses six stringent scoring criteria. Acuity can support investors in weeding out issuers enjoying an easy ride on sustainability targets and narrow down their investable list of SLBs to best-in-class instruments with clearly defined and material KPIs, to which ambitious SPTs are calibrated and the achievement of which would generate a significantly positive environmental or social impact.

### Picking winners: An outstanding issuer with ambitious sustainability goals identified by our AoT scoring pillar

Outstanding

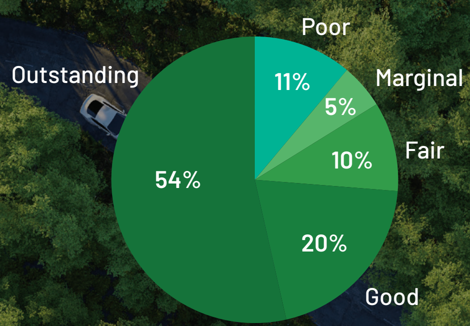
**The SLB:** A 12-year, 2.000% EUR-denominated bond with an investment-grade credit rating issued by a sustainable energy solutions company

**Benefit to the SLB issuer:** **Access to much cheaper debt,** with the bond being issued at the lowest spread over US Treasuries in the company's history

**Our 'ambitiousness of targets' impact assessment:** Acuity's scoring framework rated the bond highly on the relevance and materiality of its KPI selection, as it aligned strongly with the core KPIs for its sector as per the ICMA's KPI registry, covering GHG emissions. Moreover, its high score reflects (1) the inclusion of Scope 3 GHG emissions, which underscores its commitment to addressing its **full carbon footprint** including indirect emissions in its supply and value chains, and (2) validation of its KPIs by the Science Based Targets initiative (SBTi). The bond also scored high on our Paris Agreement criterion, and less than 16% of its SPT had been achieved at the time of issuance.

**Benefit to ESG investors of using our scoring framework:** Acuity's scoring framework will weed out issuers engaging in greenwashing by setting unambitious or easily achievable SPTs. It will identify outstanding issuers with ambitious SPTs. Fixed income ESG investors can confidently add these SLBs to their portfolios; this would present opportunities to engage with issuers previously open only to equity investors.

*Around **54%** of SLBs in Acuity's database are rated **"outstanding"** under the **"ambitiousness of targets"** pillar*




***High scorers on the "outstanding" end of the spectrum include a Singaporean technology firm's SLB issuance maturing in 2027***

***"Poor" outliers include a French aluminium producer's SLB maturing in 2029***

# ‘Cost of failure’ pillar: scoring financial penalties for missed sustainability targets

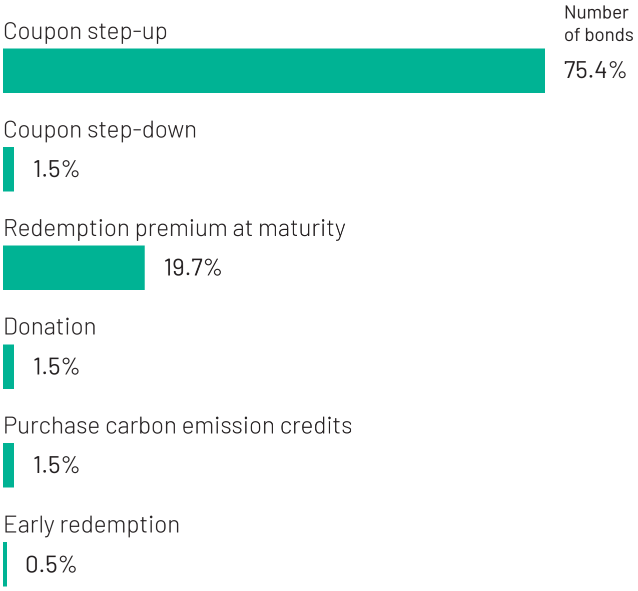
## Crunch time for SLB issuers amid looming target observation dates

The SLB market experienced its first coupon step-up trigger event in 2022, when PKN Orlen, a Polish oil refiner, became the first SLB issuer to start paying bondholders a higher coupon on two of its outstanding SLBs. Subsequently, Greek utility company Public Power Corporation (PPC) failed to meet its end-2022 target of a 40% reduction in Scope 1 $CO_2$ emissions, which triggered a coupon step-up of 50bps on its EUR775m issuance from 2023. Given that around 15 more SLB issuers have target observation dates of end-2023, and most target observation dates fall in 2025, the market could see several more coupon step-up trigger events over the next two to three years.

## Many SLBs have coupon step-ups that are too low to sufficiently incentivise issuers to meet targets

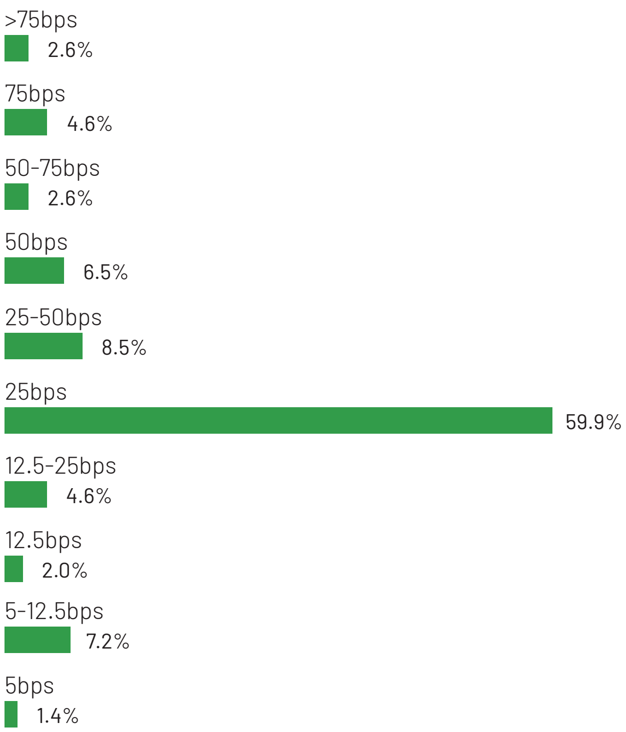
The smooth implementation of recent coupon step-up penalties should provide investors a measure of comfort that SLBs work as intended and penalise issuers that fail to meet environmental or social targets. However, we believe the step-ups in many SLB issuances are too small to incentivise issuers to meet their predetermined SPTs. For example, most of the outstanding SLB issuances have been structured with a 25bps coupon step-up penalty, regardless of the issuer’s credit rating, overall coupon or tenure. The selected coupon step-up should, in our view, have financial materiality to an issuer in order to establish credibility with investors and incentivise the issuer to meet its sustainability targets. Nevertheless, we continue to favour coupon step-ups over other forms of penalties, such as donations to charitable organisations or purchasing carbon credits (also called carbon offsets); this is factored into our scoring pillar. We believe that moral ambiguity about coupon step-ups is overdone. While it is not desirable for an ESG investor to “profit” from an issuer’s failure to meet an ESG target, we view coupon step-ups in the same manner as the coupon step-up that results from an issuer receiving a credit downgrade. The financial penalty of incurring a higher cost of debt in the event of failure is an incentive for the issuer to meet its targets.

**Coupon step-ups are the market’s preferred penalty mechanism for failure to meet sustainability targets**




Source: The World Bank (31 December 2021)

**A coupon step-up of 25bps has become the market norm, regardless of credit rating, overall coupon or tenure**




Source: The World Bank (31 December 2021)

Our scoring pillar takes a nuanced scoring approach to issuances with coupon step-downs. We recognise that they can promote short-termism by allowing an unethical issuer to set easily achievable targets and then enjoy a lower coupon. However, we believe it is also fair to reward issuers in the form of a lower coupon if they **exceed** targets, just as they are penalised with a higher coupon if they fail to meet targets. This two-way pricing could also ease the moral ambiguity of ESG investors who do not want to benefit financially from a company's failure to meet ESG targets. We also prefer issuances that incorporate an SPT redemption premium, which requires an additional premium to be paid upon early redemption in the event that redemption occurs after failing to meet a sustainability target.

***Sounding the alarm: Manipulation of structural loopholes by issuers looking for a 'free lunch': lenient financial penalties for failing to meet targets***

SLB issuers could structure their issuances such that financial penalties for failing to meet ESG targets are minimised or bypassed altogether by (1) calling an SLB before the target observation date, (2) setting coupon step-up/target observation dates close to the maturity date or (3) setting low step-up rates. Acuity's scoring framework is designed to flag such issuances under the "cost of failure" scoring pillar that encompasses nine scoring criteria. We briefly highlight one such instance below:

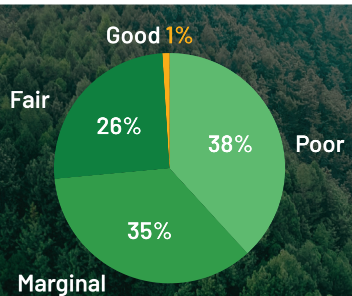
**The SLB:** A seven-year, 6.125% USD-denominated F&B sector bond with a high-yield (HY) credit rating

**Benefit to the SLB issuer:** **Access to much cheaper debt,** with the bond being issued at the lowest spread over US Treasuries in the company's history. The bond saw strong market demand and was 5.0x oversubscribed.

**Our 'ambitiousness of targets' impact assessment:** **Acuity's scoring framework rated the bond poorly on the "cost of failure" pillar given the magnitude of its coupon step-up,** as the issuance had simply adopted the standard 25bps step-up rate without factoring in its HY credit rating, resulting in a low relative impact (only 4.1% of its total coupon rate) in the event of failing to meet its sustainability targets. The bond had some positives, such as (1) no step-down clause, (2) an SPT redemption premium and (3) target observation and coupon step-up dates set three years prior to maturity, for which it was scored favourably. However, **our scoring framework rated the bond poorly on the fact that its first step-up date coincides with its first call date. This effectively means the issuer could fail to meet its pre-set ESG target on the target observation date but bypass incurring any penalty apart from the SPT redemption premium by calling the bond.**

**Benefit to ESG investors of using our scoring framework:** Acuity's scoring framework would help investors look beyond the market hype surrounding an SLB issuance. It weeds out issuers engaging in greenwashing by exploiting structural loopholes to minimise penalties for failing to meet ESG targets.

***Based on our stringent scoring criteria, only one issuer scored "good" in terms of "cost of failure***




*The high scorer on the "good" end of the spectrum was a Dutch consumer-sector issuer's SLB maturing in 2030*

*"Marginal" issuers include a Dutch chemical producer's SLBs due in 2026*

## ‘Transparency and integrity’ pillar: scoring the verifiability of progress towards SPTs

### Plans and targets: why we prefer comprehensive plans and absolute targets

We expect issuers to disclose comprehensive plans for achieving their targets with a clearly laid out timeline for future KPI achievement. Some issuers provide only interim targets, to be achieved in a year midway between the SLB’s issue date and its maturity, while the level of achievement expected in each year leading up to the interim/final KPI is not disclosed. Issuers that outline (at least) annual expected SPT achievement levels are rated high – even though missing these annual targets may not lead to a penalty being triggered – as it boosts confidence in the issuer’s sustainability efforts. Furthermore, we expect issuers to report their progress on achieving targets at least annually and to make these disclosures easily accessible via their websites, sustainability reports or universal registration documents.

We also prefer SLBs that carry absolute targets over those that carry relative or intensity targets. An absolute target refers to, for example, an ambition of an issuer to reduce total GHG emissions to 50kt of $CO_2e$ by 2025. A relative target refers to, for example, an issuer aiming to reduce total GHG emissions to 50kt of $CO_2e$ per 1EURm of revenue by 2025 – this is a ratio of emissions-to-revenue. We believe that relative targets are less ambitious, as the ratio could be subject to manipulation by the issuer to report a reduction in emissions intensity, when in actuality, higher absolute emissions (the numerator) could have been more than offset by even higher revenue (the denominator).

However, absolute targets are not immune to manipulation either, as evidenced by the recent divestment of coal plants by an Asian energy company, where the company in question retains the right to use the assets that would appear as financial assets on its balance sheet as opposed to physical assets. The company’s absolute emissions would reduce – but only on paper, not in reality. This gives rise to the question of whether a company is truly ambitious about its sustainability targets if it merely shifts ownership of unsustainable assets rather than shutting these assets down completely. Therefore, our ratings framework factors in issuers’ ESG track records, on a case-by-case basis, and notches ratings based on their history of sustainability practices.

***The sustainable financing market becomes more efficient as impact investors are drawn to transparent issuers***

**The SLB:** A seven-year, 2.375% EUR-denominated hospitality-sector bond with an IG credit rating

**Benefit to the SLB issuer:** **Optimisation of its cost of debt,** with proceeds used to refinance existing debt that includes a EUR500m 3.625% bond due in September 2023. The SLB saw strong market demand and was 3.5x oversubscribed.

**Our 'transparency and integrity' impact assessment:** **Acuity's scoring framework rated the bond outstanding under this pillar,** as (1) the issuer's SLB framework discloses a clear timeline of annual interim targets, (2) the issuer would report SPT achievement levels at least annually or more frequently when required and (3) KPI achievement levels would be disclosed both on the corporate website and in its universal registration document or in a sustainability report, together with any additional information on material changes to KPIs. The issuer has also set absolute Scope 1 and 2 (SPT 1) and Scope 3 (SPT 2) reduction targets, which we score positively.

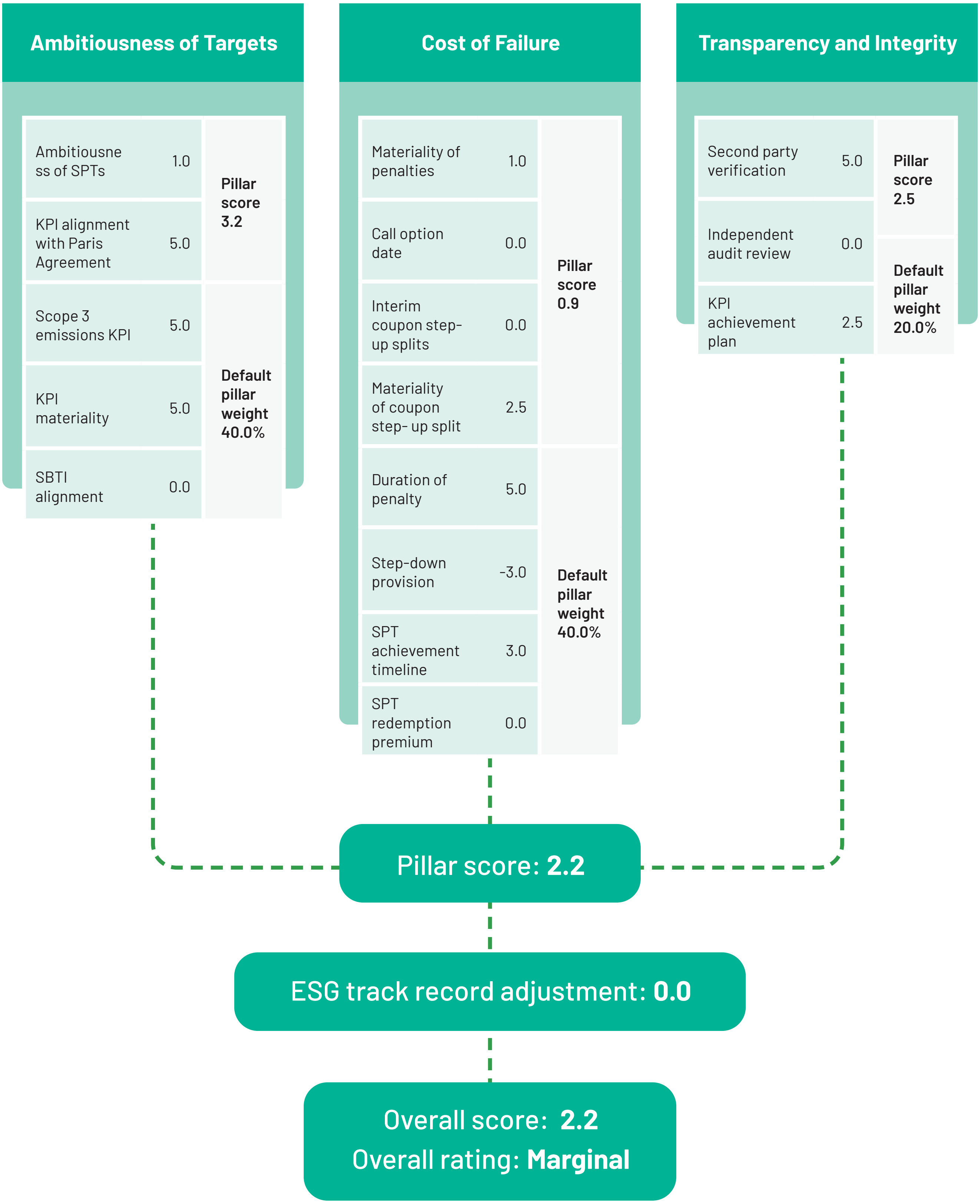
**Benefit to ESG investors of using our scoring framework:** Investors need to monitor the progress of SLB issuances towards achieving their SPTs. Acuity's scoring framework will help investors identify issuers that would provide relevant, material, up-to-date and accurate information following issuance, and avoid issuers that seek to greenwash at the reporting stage.

## Overall rating: Identifies best-in-class SLBs across the three pillars

While our individual scoring pillars help investors zero in on, and overweight, their primary area of concern relating to SLBs, our overall rating scale picks out the best-in-class SLBs across the 16 qualitative and quantitative scoring criteria. We provide a sample of our analysis, and ranking, of a sovereign SLB issuance (Uruguay's) in our database below. Our scorecard ranked the sample issuer – an emerging-market sovereign issuer – as "marginal". The issuance's KPIs were clearly in line with its targets set under the Paris Agreement but fell short in terms of the cost of failure, with the coupon step-up penalty having an immaterial impact relative to its coupon rate. Furthermore, we assessed that the sovereign had achieved most of its targets at the time of issuance (92.6% average achievement across SPTs); thus, it scored poorly on the ambitiousness of targets. However, we do not notch down Uruguay's rating, given its exemplary ESG track record and its strong position in the 83rd percentile of the World Bank Governance Indicators as of June 2023.

We welcome the issuance of the first sovereign SLBs by Chile and Uruguay in 2022 as a key milestone for this nascent asset class in the transition to net zero. It underscores the ability of SLBs to facilitate a link between national climate and environmental commitments and a country's financing strategy, incentivising emission reductions by way of coupon step-ups or two-way pricing mechanisms (includes a step-down in the event targets are reached).

**Sample rating of an SLB issued by the government of Uruguay in 2022**




Source: Acuity Knowledge Partners

## Conclusion

Fixed income ESG investing is evolving rapidly from niche to mainstream, with more investment portfolios being managed with climate mandates, specifically with carbon-reduction targets. While energy companies often get all the bad press from an ESG perspective, there are several other hard-to-abate sectors such as metals and mining, materials (cement, steel, etc.), aviation and utilities that were previously excluded from traditional ESG-focused portfolios. However, with growing focus on stewardship of assets, investors are increasingly recognising the importance of being invested in these sectors in order to work with these issuers to transition to a carbon-neutral economy.

Given that it has been less than five years since the issuance of the first SLB, the market is likely to continue to experience growing pains as bond structures evolve and scrutiny by investors, regulators and other stakeholders intensifies, similar to the breaking-in period experienced by green bonds and other use-of-proceeds bonds. However, there is no doubt that SLBs are here to stay and have the potential to play a transformational role in financing the climate transition for carbon-intensive, high-polluting sectors, including materials, metals and mining and oil and gas, which typically do not participate in the use-of-proceeds bond market. While Europe remains the epicentre of SLB issuance, issuance volumes are growing steadily across Asia, Latin America and the US. Moreover, SLBs continue to proliferate in the sub-investment-grade space and could eventually become the ESG instrument of choice for high-yield issuers. Increased regulatory oversight and the gradual implementation of market standards, coupled with improved bond structures, should help sustain the momentum in the initial phase of this nascent asset class. Investors who wish to participate in the burgeoning SLB market should, however, do their homework in terms of both fundamental credit research and SLB selection to avoid falling prey to "sustainability washing" by unethical issuers, and then closely monitor each issuer's progress towards achieving its stated sustainability targets. Acuity stands ready to help clients identify best-in-class SLBs through the use of its proprietary rating product and complementary in-house database.

## Authors

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Lourdeena Kudaliyanage has over 12 years of experience in investment research. At Acuity Knowledge Partners (Acuity), she is part of the Fixed Income and Credit Research team in the Investment Research unit. She currently supervises a team of credit analysts covering investment-grade and high-yield issuers across multiple sectors in Asia and Europe for a global asset management firm. During her tenure at Acuity, Lourdeena has supported leading buy-side and sell-side firms covering multiple sectors, focusing primarily on frontier and emerging markets, with expertise in thematic and company research. She has authored several white papers covering fixed income and ESG topics. She is a CFA charterholder and holds a BSc Econ (Hon.) and an MSc in Financial Management from the University of London.

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# About Acuity Knowledge Partners

Acuity Knowledge Partners (Acuity) is a leading provider of bespoke research, analytics and technology solutions to the financial services sector, including asset managers, corporate and investment banks, private equity and venture capital firms, hedge funds and consulting firms. Its global network of over 6,000 analysts and industry experts, combined with proprietary technology, supports more than 600 financial institutions and consulting companies to operate more efficiently and unlock their human capital, driving revenue higher and transforming operations. Acuity is headquartered in London and operates from 10 locations worldwide.

Acuity was established as a separate business from Moody's Corporation in 2019, following its acquisition by Equistone Partners Europe (Equistone). In January 2023, funds advised by global private equity firm Permira acquired a majority stake in the business from Equistone, which remains invested as a minority shareholder.

## Our expertise includes the following:

- Investment Banking: origination and trading support
- Investment Research support: covering all asset classes in terms of ideation, data science, and research support across the buy side and sell side
- Commercial Lending support: across origination, credit assessment, underwriting, and covenant and portfolio risk for all lending types
- Private Equity: origination, valuation and portfolio monitoring support
- Asset Management services support: across marketing, investment research, portfolio management/ optimisation, risk and compliance
- Corporate and Consulting services: market and strategic research; survey work; treasury and counterparty risk support; and CEO office support, including M&A, FP&A and investor relations support
- Compliance support: AML analytics, KYC, counterparty credit risk modelling and servicing across banks, asset managers and corporates
- Data Science: web scraping, data structuring, analytics and visualisation These services are supported by our proprietary suite of Business Excellence and Automation Tools (BEAT) that offer domain-specific contextual technology.

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