iGRAVITY

"Green Bonds: How to Optimize Impact and Returns"

Abstract

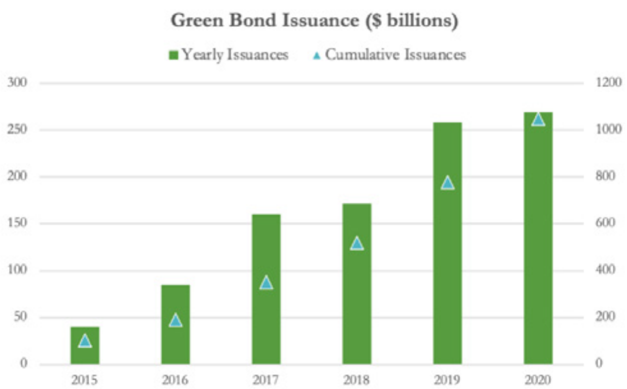
Tackling climate change is becoming increasingly a priority for fixed income investors. However, they face two important challenges:

- Now that almost every company is declaring that they live and breathe sustainability, and that they are investing heavily into *Green* projects, **how can investors actually identify what is *Green* and what is not?**
- On the other end, yields are currently at all time-lows and investors are struggling to deploy capital. With everyone's attention currently centered around Green Bonds, investors are left wondering **where to find attractive opportunities in that market.**

In this executive summary, we will share the key takeaways from our research and conversation with Green Bond expert Lili Hocke from Sustainalytics, as well as our view on where to find attractive opportunities in the Green Bond market.

For those that may not be familiar with the term, the following definition is commonly used in the market: **"Green Bonds are bonds which include a commitment of the issuer to allocate proceeds to activities that have a positive environmental impact".**

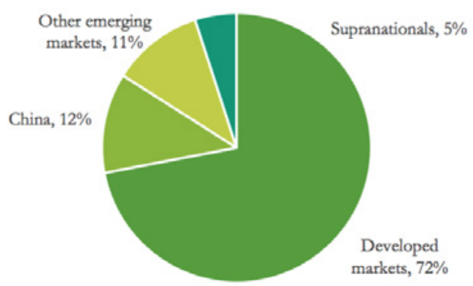
The market



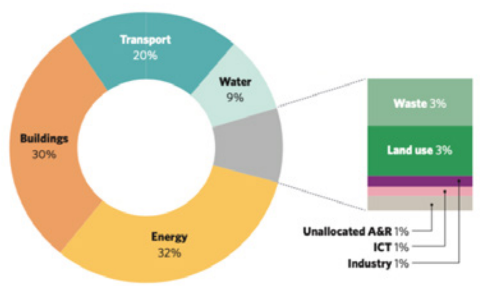
The Green Bond market has been growing steadily over the last 5 years, at a CAGR of over 46%, and has just hit over a trillion USD in cumulative issuances. While 2020 was relatively flat YoY for green bonds, this year saw the rise of new labels: sustainability and social bonds. Which together represented an additional $251 billion in issuances. Green Bonds are expected to go back to grow over 50% in 2021.

Figure 1: Green Bond historical Issuances.
Source: Climate Bonds Initiative and Environmental Bond Database

Geographic share



Use of proceeds per category



The bulk of the issuances happen in developed markets, and are centered around three areas of investment (Energy, Buildings and Transport). Those are segments in which technology is now ripe, making it relatively easy for issuers to get a positive ROI.

China and other emerging markets are growing their share of the market, but investors face other challenges around impact and liquidity in those markets, that we will depict in the next sections. Land use projects, such as sustainable agroforestry or agriculture, are relatively more niche, but offer attractive investment opportunities.

What defines a bond as *Green* ?

General Definition: "Green Bonds are bonds which include a commitment of the issuer to allocate proceeds to activities that have a positive environmental impact".

Due to the level of complexity around sectors, geographies, and considering politics and economic interests, there is currently not a unique definition of *Green*.

Here is an overview of the main standards and frameworks used in the industry:

The Green Bond Principles

Those principles set general integrity guidelines, but fail to use specific thresholds.

Climate Bond Certified

The Climate Bonds Standards do use scientific criteria that ensure that certified bonds are consistent with the 2°C global warming objective set by the Paris Agreement. However, around 32% of the market is not aligned with those standards.

EU Taxonomy Regulations

中国银行 BANK OF CHINA

Formal regulation is coming, particularly in the EU with the current development of the EU Green Bond Standards which are expected to become active in 2021. There are important differences by region, as is the example of China where up until recently projects such as "*coal efficiency*" could be considered *Green*.

It is important to note that these standards are continuously updated, based both on new regulation and new scientific criteria being developed per sector.

SUSTAINALYTICS

Sustainalytics is a global leader in Sustainable Finance research and ratings, established for more than 25 years. They provide assessments on Green and Social Bonds, with dedicated teams present on all continents.

Lili Hocke, Product Manager of Sustainable Finance Opinion Service at Sustainalytics, explains the obvious advantages of a third party independent and systematic assessment of Green Bonds, referred to as Second-Party Opinions. Those include an in-depth analysis of the sustainability profile of the green bond framework, including the potential project categories financed, as well as processes on project selection and evaluation, management of proceeds and commitments on allocation and impact reporting. Sustainalytics uses its in-house taxonomy to evaluate green projects on their impact.

Next to the analysis of the Framework, Sustainalytics performs an assessment of the issuer's environmental and social practices through interviews, as well as public and private data analysis.

Most Opinions speak to the Framework and thus do not include an assessment of the individual projects financed with a particular issuance. Issuers can request an Annual Review in which Sustainalytics validates that the projects financed are indeed aligned with the criteria outlined in the Framework and that impact reporting in conducted in alignment with the commitments made in the Framework.

There are other providers of second-opinion services for Green Bonds. An intuitive way of considering *Green* investments is to use a scale developed by the Green Bond second-opinion provider, CICERO. Typically CICERO will rate the projects between brown (for those that do not pass minimum criteria) and light, medium and dark green (for those considered as environmentally friendly). However, this provider is almost entirely focused on Scandinavian companies.

	Light Green	Medium Green	Dark Green
Definition	Projects and solutions that are climate friendly but do not represent or contribute to the long term vision.	Projects and solutions that represent steps towars the long-term vision, but are not quite there yet.	Projects and solutions that correspond to the long-term vision of a low carbon and climate resilient future.
Example	Efficiency investments for shipping technologies where clean alternatives are not available.	Bridging technologies such as plug-in hybrid buses.	Wind energy projects with a strong governance structure that integrates environmental concerns.

While those classifications are useful, they only show a part of the picture: a company investing in some renewable energy project could issue a *Dark Green* Bond, while having its core business centered around environmentally damaging activities, such as producing bottled soft drinks.

Sustainalytics' view: Lili Hocke explains that they will not only look at the use of proceeds of the bonds, but will also consider the overall sustainability strategy of the company. This is done in order to ensure the credibility of the company as a green bond issuer.

Since the market for Green Bonds includes more than pure impact companies, Sustainalytics' analysis of the company provides an indication about the stage of the sustainability journey the company currently finds itself in. The investor needs to make his/her own decision on whether the company fits into his/her investment strategy.

iGravity's view: We believe one should look beyond the Green Bond label, and verify whether the use of proceeds are aligned with the Climate Bonds Standards, which have been developed using scientific criteria.

In that process, second-opinion reports from firms such as Sustainalytics are great tools to streamline the analysis.

We also make a distinction between a company doing an investment that strengthens their ESG profile, and an Impact investment, which focuses on solving some of the world's most pressing issues. iGravity solely invests in companies whose core business is centered around impact.

Where to find attractive investments

As seen in previous sections, the bulk of the Green Bond issuances are made in developed markets. With yields currently at all-time lows, Green Bonds don't escape this fact.

Buying the market doesn't look very attractive. As an example, the leading iShares Global Green Bond ETF currently yields 0.31% [2].

On the other hand, Emerging Market Corporate Bond spreads currently stand at 2.83% [3].

While investors have to be considerate of other risks such as country and currency risks, and increased volatility, this opens the door to hand-pick attractive risk-adjusted bonds issued in EM.

iGravity's view: We believe the risk-return profile of low-yielding developed market bonds to be unattractive.

While some investors wonder about the existence of a potential *Greenium* (i.e. Green Bonds issuers being able to issue debt at lower rates), studies are currently mixed as to whether there is a statistically significant difference in yields between Green and Vanilla Bonds.

There are attractive opportunities in Emerging Markets, though investors have to mitigate risks and look for credit quality in those markets. We also consider important to focus on export companies in order to avoid risks of Emerging Markets currency devaluations.

Finally, investors can further improve their prospects if they invest in slightly less liquid markets, where we see additional liquidity premiums of 1-3%.

[2] *https://www.ishares.com/us/products/305296/ishares-global-green-bond-etf (29.01.2021)*
[3] *ICE BofA Emerging Markets Corporate Plus Index Option-Adjusted (29.01.2021)*

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