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The greening of corporate culture

Rapid growth of green bonds shows that investors are seizing the opportunity to drive energy transition

Key takeaways:

- Green bond issuance rose to $34bn in 2016, providing greater diversification potential within green bond portfolios. There is no reason today why green bonds cannot be part of the core credit strategy.
- The challenge for ESG investors is to select good green bonds. Only an asset manager whose primary business activity is ESG, with large resources[1] and deep knowledge of the green bond sector, can help take up this challenge.
- Chris Wigley from Mirova explains how a concentrated green bond portfolios can add value, after a skilled stock selection and an assessment of their intrinsic value.

The greening of corporate debt is quietly starting to change how companies raise and spend capital. The issuance of green bonds is accelerating fast and the capital is increasingly being used for energy transition efforts, reflecting mutating corporate attitudes and aims.

Green bonds, which are designed to finance projects that offer environmental benefits, have attracted substantial supply-side interest. Issuance has risen from $27bn in 2014, to $31bn in 2015, to some $34bn in 2016[2].

The volumes have surged as many companies wanting to finance environmental-related projects issue green bonds rather than standard corporate bonds, whose financing targets are usually unspecified.

What motivates issuers to "go green"?

Issuing green bonds sends a signal to the market and stakeholders about their commitment to sustainability. Issuing green bonds also diversifies the investor base. The biggest driver of recent times, however, is that companies see a huge opportunity to raise finance that can transform old, inefficient energy infrastructure into efficient and environmentally-friendly energy practices.

Chris Wigley
Senior Portfolio Manager
Mirova

Many market-leading companies have realised that energy transition will be one of their biggest challenges in the future and are now positioning themselves to meet the challenge and create a competitive edge through it.

Take Apple[3], the world's largest company by market capitalisation. In early 2016, it issued the largest ever corporate green bond in US dollars - $1.5bn – which took many analysts by surprise. Does Apple really qualify as an ESG investment? Mirova's ESG analysts looked closely at the features of the issue and decided it was a genuine milestone for the green bond sector. Apple was clearly genuinely trying to effect an energy transition by investing in renewable energy sources, water sustainability, researching more sustainable materials for its products and recycling old devices.

We are hopeful that other household names in the US and beyond will look to overhaul their business practices too and issue green bonds to help them do so.

A corporate makeover

Whereas the green bond market has been dominated by quasi-government issues, corporate green bonds are growing fast and now represent the single largest issuer type, at 40% of the market[4].

We have seen corporate issuance from a number of major companies in 2016 in most of the major currencies. Overall, 45% of issuance has been in dollars, 40% in euros and 5% in sterling[5]. In the US, Southern Power, a utility, launched a $0.9bn issue in November 2016, its seventh such bond as it shifts to becoming a major provider of renewable energy.

European companies came later to the party, but over the summer of 2016 the market saw green bond issuance from Dutch utility companies and banks, French Banks such as Societe Generale, and BNP and other European utilities. In Spain, Iberdrola issued its third green bond, and renewable energy now provides 30% of its total output.

This focus on energy transition is rational in a fast-moving corporate world where failure to adapt to new paradigms can lead to surprisingly rapid corporate decline. Whereas green bonds have tended to be used for energy efficiency and transport projects up until now, increasingly they are targeted at climate change adaptation activities, such as waste management and sustainability.

The types of green bonds are broadening and deepening

The growth of issuance has led to a widening of issue types and a deepening of the market. In the early days of green bonds, maturities tended to be relatively short. As investors gain confidence in them, maturities are extending deep into the future, with the European Investment Bank in September 2016 issuing the longest ever green bond, with a maturity of 21 years. This was slightly longer than an issue by the Dutch utility TenneT, which launched a 20-year bond in mid-2016.

Emerging markets are getting the green bug too. Chinese banks have issued bonds in both RMB and dollars. Meanwhile, issuance from India is starting to drip-feed into the market. In Mexico, the stock exchange held a green bonds conference in March 2016 which drew an unexpectedly large number of investors and corporates. In Brazil, the national banking body has drawn up guidelines for corporate issuance of green bonds.

As a result of this activity, the Barclays MSCI Green Bond index now contains 140 securities, compared with just 40 issues when the index launched in late 2014. While most bonds have investment grade ratings, single A-rated bonds are growing. From an investor's point of view, this means more diversification within green bond portfolios is now possible.

How to select green bonds

Like all sectors, there are good securities and poor ones. The challenge for ESG investors is to select good green bonds. What do we mean by this? Some examples: first not all projects will actually deliver environmental value. Just because a wind farm produces renewable energy, that doesn't mean its impact will necessarily be all positive.

Second, some green bonds lack transparency. This is perhaps understandable in a young sector, but investors need to have visibility over their investments.

Third, the governance of some green bonds is stronger in some cases than in others. For instance, it's vital for the integrity of the sector that the green bond is not used for general corporate purposes, but only for the project outlined in the prospectus and by the entity described.

These and myriad other issues can only be addressed by a fund manager whose primary business activity is ESG. Whereas conventional fund managers tend to look at ESG issues last, Mirova's first assessment of bonds is carried out by our 12-strong ESG team. Mirova has deep knowledge of the green bond sector in particular.

This is important in understanding and interpreting the Green Bond Principles (GBP), for instance, which were reissued and expanded in June 2016. Under the revised GBP, the green bonds edifice has four pillars to guide investors:

1. Use of proceeds
2. Process for project evaluation
3. Management of proceeds
4. Regular reporting.

While these principles are all important, Mirova's experience in this sector tells us that numbers 1 and 4 are the most critical. We look at these issues first before going on to consider other green and financial variables.

Valuation is a critical part of the process. These days, with growing issuance levels, it is not so hard to find good quality green bonds supporting good projects and with good governance. But not all offer good value.

We are prepared to wait for new issues that offer value or to buy bonds on secondary markets at the right time. Some bonds are upgraded if the issuer becomes more profitable or shows itself to be more adaptable to the new energy environment. We don't necessarily seek to invest in bonds from the most sustainable companies today, but to allocate to companies that are capable of improving their ESG profile over the coming years.

What's in it for investors?

The high demand for green bond issues demonstrates the attractiveness of the asset class to investors. They like the transparency of the asset class: because of the constraints on issuers of green bonds, there is much more precision and transparency over the use of the proceeds.

Importantly, returns are determined by the credit rating of the issuer, so investors receive the same rate of return - for a given issuer - whether the bond is green or not. While many investors in green bonds have a buy-and-hold approach, Mirova tries to outperform the green bonds market, over rolling three-year periods. It does this by creating concentrated portfolios after a skilled stockpicking and by buying and selling bonds based on value rather than on their weight in the index In particular, it looks for issues that have the potential to be re-rated.

Do green bonds suit all investors?

Green bonds are increasingly bought by institutional investors who are attracted not just by the impact reporting, but in knowing exactly how the capital is being used by the company.

While green bonds may have been regarded by institutions as a satellite strategy within the portfolio, recent growth and sophistication in the market has created a universe that broadly mirrors the wider bonds market.

In addition, as the green bonds sector moves closer to critical mass, it has made a positive impact on mainstream credit markets. One investment bank, for instance, has started to report how it uses the proceeds of its bond issues, which is unusual in a corporate marketplace that prefers to put capital raised to general use.

Given their rapid growth and influence in the market, there is no reason today why green bonds could not form, or be part of, the core credit strategy.

Conclusion – an ongoing shift

Green bonds can be viewed as part of a wider move towards purpose-based investing. Both green and social bonds – the forerunner of green bonds - are part of that move. This shift to purpose-based investing is likely to accelerate as millennials become key investors and demand that their investments are aligned with their values.

These values should be reflected well in the three principal USPs of green bonds:

- The market return is similar to that of a comparable conventional bond, so there is no return sacrifice.
- Investors get information about how the proceeds of the bonds are used and can employ metrics to see the positive ESG impact they are making.
- Regular reporting gives investors increased visibility over their investment relative to traditional bonds.

Written on 7 December 2016

1 12 ESG analysts. Source : Mirova, as of end November 2016.
2 Source : Natixis 'SRI Green and Sustainable Bonds' September 2016
3 The submitted information can be construed as reflecting the opinion of Mirova as of the date of this document and may change without notice.
4 Source: Bloomberg Barclays Global Green Bond Index
5 Source: Bloomberg Barclays Global Green Bond Index

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