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Client Alert Commentary

Latham & Watkins ESG and Sustainable Finance Practices

May 15, 2023 | Number 3103

Sustainability-Linked Bond Issuers Miss Sustainability Targets: 10 Takeaways

Issuers should consider the ambitiousness of their sustainability targets, any challenges in achieving the targets on schedule, and how they will prove their progress.

The global market for sustainability-linked bonds[1] (SLBs) has grown significantly in recent years and, according to the 2022 Sustainable Finance Review published by Refinitiv, SLBs totaled US$744.3 billion in 2022.

Unlike green, social, or sustainability use-of-proceeds bonds, which require issuers to use the proceeds from such offerings to finance specific projects, SLBs allow issuers to use the proceeds for general corporate purposes. However, SLBs require issuers to set pre-defined sustainability/ESG objectives, which are measured through predefined key performance indicators (KPIs) and assessed against predefined Sustainability Performance Targets (SPTs).

While issuers continue to commit to sustainability/ESG objectives, for the first time since SLBs emerged, certain SLB issuers missed their sustainability targets in 2022 and early 2023:

- a European high-yield SLB, which missed its ESG rating-linked SPT as a result of a downgrade of its ESG rating;
- a European SLB, which missed its interim target for renewable energy use; and
- a European high-yield SLB, which missed its 2022 carbon emissions SPT.

Further, market participants have recently expressed concerns about other SLB issuers in danger of not hitting their SPTs and, in general, about the credibility of SLBs in light of issuer ambitions and incentives to achieve sustainability targets.[2]

This Client Alert provides 10 takeaways relating to these developments for potential SLB issuers and their underwriters.

10 Takeaways

1. These recent developments provide an important reminder that there is no default or event of default under an SLB if an SPT is missed — the only contractual remedy/consequence is the relevant interest rate step-up (or such alternative contractual consequence) specified in the bond documentation.

2. While there will be a direct financial impact (see first point) under an SLB if an SPT is missed — typically in the form of an interest rate step-up — no such impact will occur if an interim performance target[3] is missed.

3. The quantum of the interest rate step-up (or specified alternative) may not always be "meaningful relative to the issuer's original bond financial characteristics," as required for alignment with the Sustainability-Linked Bond Principles (SLBPs) published by the International Capital Market Association (ICMA). In some cases, the quantum is arguably insufficiently material to incentivize issuers to prioritize achieving their SPT when circumstances are not conducive, such as during the energy crisis following the commencement of hostilities in Ukraine.

4. Issuers should give careful thought to the calibration of their SPTs so that they are suitably ambitious, but also achievable. Further, issuers should consider and disclose how they intend to achieve their SPTs and the key challenges they expect to face. This disclosure should align with the issuer's broader transition strategy, which should also be disclosed (ideally in accordance with ICMA's Climate Transition Finance Handbook[4]).

5. Certain SLBs include a non-call period that falls inside the first possible interest rate step-up, so that if an SPT is missed, the SLB could be called before the step-up actually applies. Whether used or not, exercising this call option is generally regarded poorly by the market. Moreover, according to the SLBPs, if an evaluation of the issuer's performance against at least one SPT prior to the bond becoming callable at the issuer's option at a pre-determined price is impracticable, investors will likely expect the call price to reflect an assumption that the SPT has not been met.

6. Issuers should carefully consider and accurately disclose any recalculation policy. A recalculation policy may enable (or require) an issuer to amend its KPIs/SPTs if certain material events occur (e.g., material M&A or force majeure events). Recalculation policies can help address situations that materially impact the relevance of the KPIs or the ambitiousness of the SPTs, and are particularly relevant given the recent material impact of the dislocation of European energy supplies resulting from the Ukraine war. For example, in certain jurisdictions, some issuers have been affected by government measures designed to support domestic energy security, including by focusing on domestic coal energy supply as a temporary alternative to Russian gas.

   Issuers considering an SLB transaction should consider whether establishing and disclosing a recalculation policy makes sense for their instrument.[5] Questions to ask include:

   - To what extent does the company wish to or need to include a recalculation policy?
   - Which types of events does the company want to capture?
   - Does the policy need to be carefully described and disclosed in the bond document?

Recalculation policies are fairly prevalent in practice given the types of events, both within and outside of an issuer's control, that could cause the SPT to be missed, despite the issuer's good faith. The terms of such policies, however, must be balanced to avoid allegations of greenwashing if the policy is invoked.

7. Third-party ESG ratings are currently largely unregulated, and their methodologies differ. In the early days of SLBs, issuers were more likely to use ESG ratings as KPIs, over time, issuers of SLBs have generally avoided ESG-rating-linked KPIs because the ESG ratings can be inconsistent and are outside of the issuer's direct control. The current trend to avoid ESG-rating-linked KPIs in SLBs will likely continue.[6]

8. Certain ESG funds and investors may be required (or feel obliged) to sell their SLB holdings if they miss their SPT, which could materially impact SLB trading prices. However, the extent to which SLBs are considered "sustainable investments" per the EU's Sustainable Finance Disclosure Regulation (SFDR) and/or are held by investors or funds with clear ESG mandates varies, and previous announcements of SPT misses have not always resulted in material sell-downs.

9. If an issuer misses an SPT to a significant extent, its reputation may be negatively impacted, and it may also find raising sustainable finance to be harder in the future. Extenuating circumstances unforeseen by the issuer's sustainability strategy do arise, and issuers should consider making quantitative and qualitative disclosure of the causes and constraints that led to a non-achievement of the SPT, as well as the mitigating action it is taking, particularly if there are other SPTs that will be tested in the same SLB or in other SLBs issued by the same issuer.

10. We have not seen any "ESG consents" as of yet — though these may emerge if issuers wish to approach investors and recalibrate the SPT based on new circumstances. For example, a utility may have set a goal to reduce its Scope 1 and 2 emissions within a seven-year timeframe based on a plan to bring renewable energy assets online and transition other conventional power generation facilities from natural gas to hydrogen. However, the disruptions caused by the conflict in Ukraine meant that energy security concerns became more significant, and funds had to be directed to securing natural gas supplies. The issuer could seek investor consent to extend the SPT (assuming the maturity of the SLB permitted).

Conclusion

In the past few years, we have seen a sharp increase in greenwashing allegations, ESG litigation, and legal claims relating to the structure and disclosure in respect of SLBs, each of which can carry serious consequences, most notably on companies' reputation and market standing. These recent — and any future — instances of issuers missing their SPTs will only intensify the attention on greenwashing, which remains an important focus for all stakeholders in the sustainability market. Companies considering an SLB transaction should carefully review ICMA's SLBPs and related guidance documents, which provide "best practice" guidelines for SLB transaction structuring features, disclosure, and reporting.

Although companies are experiencing increasing pressure from various stakeholders to make commitments to a greener and more sustainable future, when preparing for SLB transactions, issuers and their advisers should pay close attention to the ambitiousness of their sustainability targets, the possible challenges in achieving such targets on schedule, as well as the methodology used to prove their progress, which can be critically important in the event of enforcement action or litigation.

Latham & Watkins will continue to track global developments in this fast-moving area.

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Endnotes

[1] The International Capital Market Association defines sustainability-linked bonds as "any type of bond instrument for which the financial and/or structural characteristics can vary depending on whether the issuer achieves predefined Sustainability/ESG objectives."

[2] See S&P Global's report "Sustainable bond issuance will return to growth in 2023" published on March 20, 2023, which is available at the following link: https://www.spglobal.com/esg/insights/featured/special-editorial/sustainable-bond-issuance-will-return-to-growth-in-2023.

[3] As used with respect to one or more KPIs to which an issuer has committed, an interim performance target is a predefined measurable improvement in the applicable KPIs evaluated over time before maturity. An interim performance target is meant to serve as a functional measurement track record on the selected KPIs and also to reflect the issuer's commitment to make consistent progress.

[4] The Climate Transition Finance Handbook is available here: https://www.icmagroup.org/sustainable-finance/the-principles-guidelines-and-handbooks/climate-transition-finance-handbook/.

[5] By providing for a recalculation policy in the initial issuance documents, the issuer will also avoid the need for a noteholder consent solicitation in the event of material changes affecting the issuer's predefined KPIs and/or SPTs, which would otherwise require the consent of the noteholders to amend the documents governing the notes.

[6] While in the most recent years issuers of SLBs have generally avoided ESG rating-linked KPIs and while we expect the current trend to continue, the use of ESG ratings is still common in connection with extensions of sustainable loans.