GENERALI INSURANCE ASSET MANAGEMENT

FOCAL POINT

EM ESG issuance: Gaining traction

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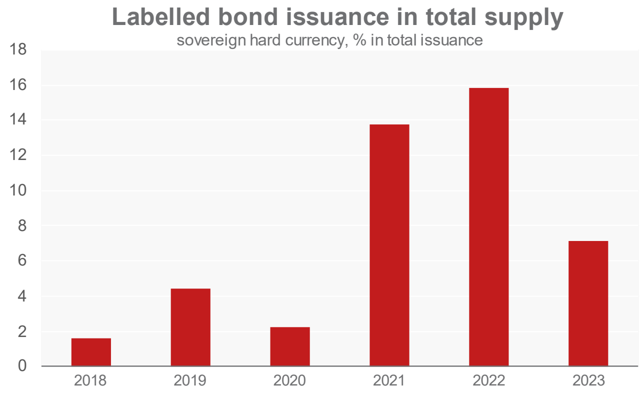
Our Focal Point series explores topical issues on macro, markets and investment

- **Despite a challenging environment, the share of EM ESG issuance in the sovereign space increased last year. The Ukraine invasion has brought about a significant change in the perception of ESG sovereign risk and we anticipate further growth in EM ESG sovereign issuance alongside the development of the ESG sovereign framework.**
- **EM sovereigns have lower ESG ratings than DM countries while requiring investment inflows to fund their ESG transition. Although labelled bonds have received criticism, they play a role in driving investments toward ESG projects in EM countries and are part of the solution.**
- **The focus of EM ESG sovereign issuance will remain on the investment-grade (IG) space, with new IG countries issuing their first labelled bonds. Sustainable and green bonds will continue to represent the bulk of the issuance.**
- **In 2022, a few EM countries issued their first sovereign Sustainability-Linked Bonds (SLBs), which are a relevant tool for aligning investors' and issuers' objectives. However, there are relevant caveats. We anticipate more issuance but from EM countries that are already advanced in their ESG issuance policy and have good ESG ratings.**
- **EM labelled bonds greenium varies significantly by bond and country. We anticipate it to tighten as EM ESG issuance gains traction.**

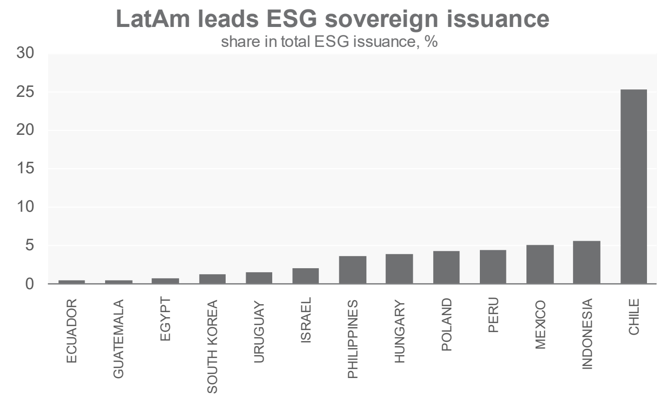
EM ESG issuance has been growing steadily over the past few years, alongside the gradual development of the ESG sovereign framework, gaining more traction. First, we will deal with the structure of the EM sovereign issuance. Then we will expose the reasons why issuance will grow further. We will finish with a focus on SLBs and the greenium.

An IG market concentrated on sustainable bonds

Like DM corporates, EM ESG issuance has initially focused on the corporate sector. This is not surprising, as the implementation of the ESG framework has been slow in the sovereign space and remains less advanced than in the corporate sector. However, there has been a noticeable acceleration in its implementation lately. Despite a 42% decline in gross issuance for EM sovereigns in 2022, the share of EM ESG sovereign issuance has gained traction, reaching 16.0% of total sovereign issuance, compared to 13.9% in 2021.

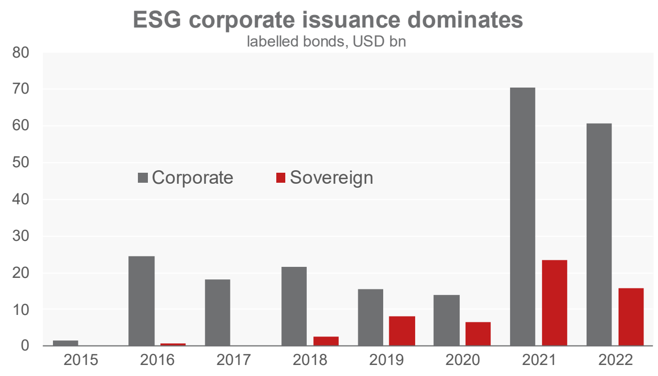


Source: Bloomberg, GIAM calculations



Source: Bloomberg, GIAM calculations

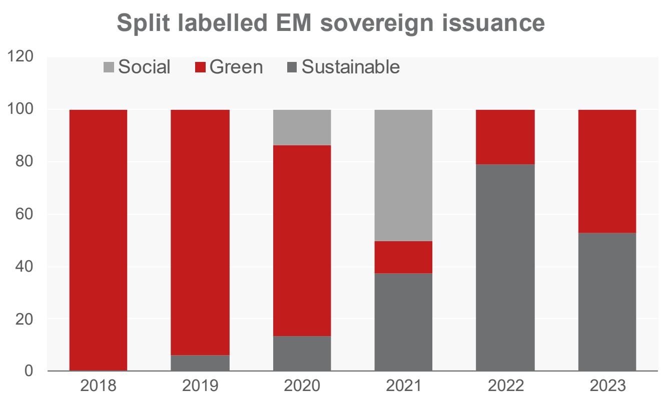
Most of the sovereign issuance has been in the investment-grade (IG) segment, with very few exceptions in the high-yield (HY) space. Egypt was the most notable HY issuer of a green bond in 2020. Since then, the market has remained predominantly IG, with a gradual extension to the HY segment but only on an opportunistic basis. This is because there is a strong positive correlation between ESG country ratings and GDP per capita, resulting in a bias towards higher ESG ratings in richer (IG) countries. EM HY countries tend to focus less on ESG topics and instead prioritize financing for general purposes or debt rollover when their fiscal positions are precarious. This makes the use of proceeds of labelled bonds a significant constraint. Even if EM HY countries issue labelled bonds, these bonds may not be investable for all ESG investors given their low ESG ratings. Moreover, the natural EM HY investor base tends to be EM specialists with a limited interest in ESG.



Source: Bloomberg, GIAM

In terms of regional distribution and bond structure issuance, LatAm countries dominate, especially Chile, which has been the most active and innovative country with the first-ever sovereign sustainability-linked bond (SLB) issued last year. EMEA is following, and we expect further issuance from CEE countries due to the higher relevance of ESG in Europe compared to other regions. GCC countries are laggards, but there are noticeable changes, with the first green bonds issued by the PIF (Saudi Public Investment fund) in 2022 and the development of Saudi Arabia's green bond framework.

Sustainable bonds continue to represent the bulk of labelled bonds, with a noticeable rise in 2022 at the expense of green and social bonds. Social bonds lag, but the growing issuance of social bonds in the DM corporate area suggests more issuance in the sovereign space. However, EM sovereigns have primarily focused on energy transition and greenhouse gas emissions. The room for manoeuvre in the social space seems to be more limited, and so do the prospects for social bond issuance.



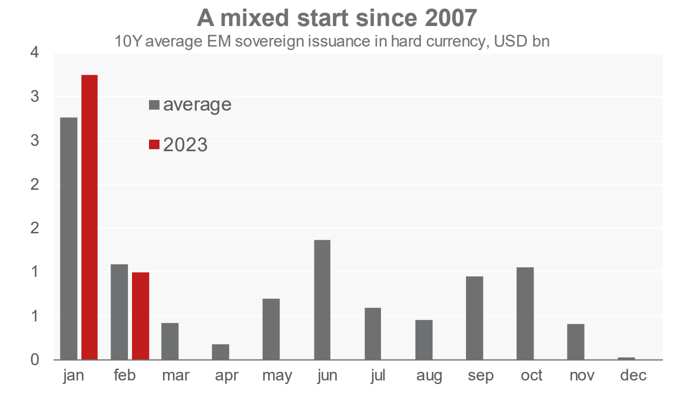
Source: Bloomberg, GIAM

Growing EM sovereign ESG issuance

The start of 2023 has been slow, with only USD 4.3bn of ESG issuance year-to-date. However, we expect the pace to accelerate, and the share of ESG in total EM sovereign issuance to increase further. Indeed, the beginning of the year was unusual. After a dismal 2022 year for EMs, the largest IG issuers had to test the primary market with conventional issuance. When the dust settles, and market conditions become more ordinary, ESG issuance will pick up.

In the medium to long term, several factors will push for a structural increase in EM ESG sovereign issuance in our view. Firstly, it will increase as the ESG sovereign framework develops further and becomes more detailed and tested. The Ukraine invasion has been a game changer in the development of the ESG sovereign framework, which lagged the ESG corporate one. Research (e.g., by the World Bank) an increased familiarity with the instruments and the war in

Ukraine have shed light on ESG at the sovereign level, raising multiple questions. For instance, on ESG sovereign ratings, there were increasing scrutiny on criteria used to exclude a country from the investable universe or on the correlation of the ESG ratings with per capita income (the ingrained income bias). All this incentivises investors to have an ESG view. One example is the new perception of the geopolitical risks in Kazakhstan, whose economy via the CPC pipeline is strongly connected with Russia or the risk of investing in China due to the relationships with Taiwan. With more clarity on the ESG sovereign framework and the development of ESG impact investing, demand for EM ESG sovereign products will grow.



Source: Bloomberg, GIAM calculations

Secondly, EM sovereigns, unlike DM countries, suffer from poor ESG perception. But they still must attract capital inflows to finance their energy transition, for instance. Labelled bonds can be a solution to reconcile investors' ESG demands and EM sovereign financing needs.

Thirdly, there has been a resilient demand for ESG products. Since 2020, there have been $15bn of inflows into EM ESG debt funds. They were resilient in 2022 despite the global EM outflows, with $3bn of inflows into ESG external debt funds compared to $35bn of global EM outflows.

The main caveat to this positive outlook is the different ESG approach between the US and Europe, where ESG matters more. EM sovereign credit has been, above all, a US-investor asset class, and the transition to ESG can be slower than for DM sovereigns.

In addition, the greenwashing concerns, and recent questions about the use of proceeds can reduce the appetite for labelled bonds. That being said, growing standardization like the one proposed by the EU Green bond standard will provide better standards.

More Sovereign Sustainability-linked bonds issuance?

EM countries have been at the edge of ESG issuance, with Chile and Uruguay issuing the first-ever sovereign sustainability-linked bonds in 2022, before any DM countries. SLBs have been a common instrument in the ESG corporate space, but by the specific nature of a sovereign, they offer different positives and drawbacks. We do not expect SLBs issuance to surpass classic labelled bond issuance, but we would expect more SLBs issuance in the medium term, as they are also attractive ESG tools for EM countries and investors in our view.

First and foremost, the ESG nature of the SLB instrument is attractive for EM sovereigns and investors alike. EM countries have traditionally scored poorly on ESG measures and have lagged in adopting global ESG policies. This has made some investors reluctant to buy traditional bonds issued by EM countries. The original structure of the SLBs incentivises EM issuers to meet their ESG targets, with a penalty imposed if they fail. Issuers are accountable for their KPIs, and it incentivizes a country to adopt a broad ESG policy, for example, on greenhouse gas emissions or deforestation. For green or social bonds, the use of proceeds is detailed but may not necessarily align with a global ESG policy.

Second, the SLB instrument is a relevant tool in sovereign engagement processes and likely the most transparent form of engagement. Sovereign engagement faces pitfalls, and one of them is the difficulty for investors to have a global impact on all parts of the country's administration. An SLB issuance reveals a commitment of the sovereign to pursue a broad ESG policy. By setting targets and KPIs, investor can track and monitor the progress.

Third, on the issuer side, SLBs can be a cheaper and alternative source of financing, as the pricing tends to be lower, already embedding the premia related to the step-up structure. To this extent, it is like inflation linkers that help to diversify the source of financing.

Finally, the SLB instrument is more flexible for the issuer because there is no commitment to use the proceeds for ESG projects. That being said, one of the main caveats of SLBs is the risk of greenwashing. What happens if an issuer fails to meet its key performance indicators? The financing may have been used for brown projects, which could lead to the SLB being reclassified. The positive ESG impact would be called into question, which could dampen investors' appetite for this type of product.

Above all, the main drawback of SLBs is related to their targets, which must be both ambitious and measurable, and the penalties, which must be restrictive enough. One way to measure this is to compare the total cost implied by the step-up with the total expenditures of a country. According to Morgan Stanley, the maximum fiscal burden for Chile implied by the 2022 SLB will be 0.01% of revenues and 0.06% for Uruguay. This is low compared to the total interest expenditure (e.g., 2.4% of GDP in Chile) but higher than the corporate average of about 0.00-0.05%. So far, the usual 25 bp step-up has been too low to be binding, and the rapid rise of global rates makes it even less constraining.

The payout structure of SLBs also draws criticism. If a country does not achieve its KPIs, the step-up structure can be criticized as it penalizes emerging market countries for not meeting their objectives and it rewards investors. Thus, for some investors it is not fully clear if it will promote ESG characteristics as required by the SFDR Article 8. One could argue that the promotion of ESG characteristics is intrinsic in the existence of the SLBs target. At least, the introduction of a step-down structure can bypass this issue by encouraging a country to overachieve. The World Bank has proposed an original structure to deal with some of these criticisms. It would be a special purpose vehicle (SPV) structure where payments are placed. If the KPIs are met, the contingent payment would be made to the government, and investors would be able to demonstrate measurable impact. If the KPIs are not met, investors would receive the contingent payment back.

In conclusion, SLBs can further develop at the sovereign level, but their structure needs more fine-tuning. Moreover, given their broad ESG impact, they are reserved for countries that already have a clear ESG policy and can achieve ambitious KPIs. It is not surprising, therefore, that Chile, the largest emerging market ESG issuer, was the first to issue an SLB.

An heterogenous greenium

Since the development of the labelled bond market, the greenium, or the difference between labelled and conventional bond yield, has attracted significant attention. On the one hand, the existence of a greenium is a relevant reason for a country to issue labelled bonds, being a cheaper source of financing. On the other hand, on the investors' side, it reveals a better appetite and a structural demand for ESG assets. It can also be seen as a measure of the ESG aspect of a bond.

Beyond these considerations, from a pure strategy point of view in the EM sovereign space, the greenium offers limited interest in our view. First, the number of labelled bonds is low – 40 bonds - across 14 very diverse countries. Their number is not high enough to make their average informative, unlike in the corporate space. Second, it is distorted by various factors like liquidity, the lack of comparable brown bonds, or even the measurement methodology[1].

Indeed, unlike in Germany where the twin bond strategy allows easy comparison between brown and ESG bonds, for EM countries, a synthetic brown curve must be computed.

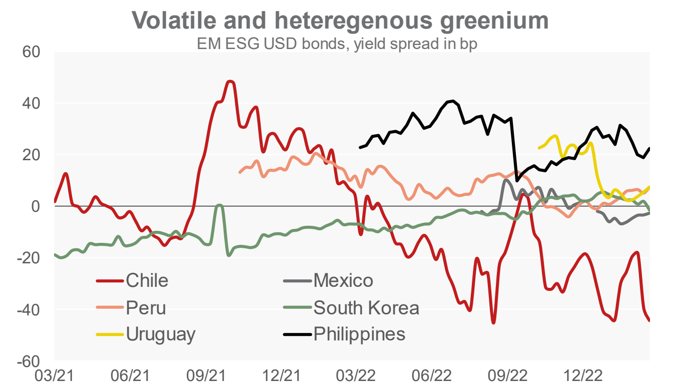
[1] Some research will compare either the z-spread difference or the yield-to-maturity, the ASW spread

Then, one can measure the spread between the yield of the labelled bond and the yield of a synthetic brown bond that has the same maturity or modified duration. It is not a straightforward exercise as the process faces many pitfalls:

- First, some countries do not have extended and complete bond curves (Hungary yen curve or trade at distressed levels (Ecuador). On the other hand, Chile has more labelled bonds than conventional bonds. In this case, the exercise should be instead to measure the *brownium* or the penalty affected to conventional bonds.
- Second, the comparison is tricky as bonds can have significant cash price differences, duration, and different liquidity, or be issued a while ago with large coupon differences.
- Third, given the small size of the labelled bonds sample, a few bonds can have a disproportionate impact on the average of the greenium.
- Fourth, there are several methodologies to compute a yield curve. Few bps of difference can eventually lead to a different interpretation.

In our view, given the limitations and the errors in measuring the greenium, the most relevant exercise is to observe the evolution of the greenium through time rather than its absolute level. To do so, we strip out distressed names and HY names where the demand is specific and do not think it is ESG driven. In addition, we focus only on EUR and USD markets where the ESG investor base is large enough.

Globally, greenium is heterogeneous through countries and bonds. Some tightening is noticeable in South Korea while it has increased in Mexico USD. Even in countries that have issued both in EUR and USD, a difference can exist. In Chile, which has been the most active ESG issuer, labelled bonds' greenium varies largely.

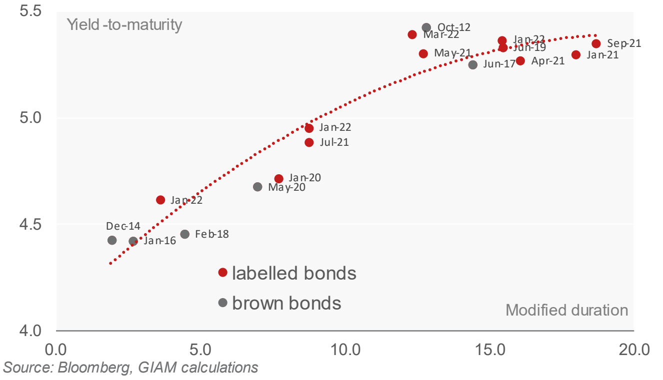


Source: Bloomberg, GIAM calculation

For EM EUR labelled bonds, on average, the greenium has gradually disappeared and has been recently volatile. The only striking result is the apparent overperformance of labelled bonds during the 2022 EM sell-off. It could be explained by the more stable nature of the ESG investor base. That said, we will downplay these results as Chile-labelled bonds represent almost one-third of the sample. Own Chile's dynamics could have a disproportionate impact.

For EM USD bonds, we observe a tightening of the greenium with labelled bonds trading now in line with conventional bonds. It is essentially driven by the Philippines' labelled bonds, which trade cheaper than conventional bonds. It raises the question of whether the Philippines labelled bonds are bought by ESG funds: the Philippines are on the FATF Grey list and so can be excluded from the investable universe by certain investors. ESG bonds issued by countries with poor ESG metrics are not necessarily eligible.

Chile USD curve: more labelleds bonds



Source: Bloomberg, GIAM calculations

Conclusion

EM-labelled bonds are a significant and increasing share of EM sovereign issuance. Yet, EM countries face a difficult environment where ESG importance is growing, but their low ESG ratings can limit investment inflows. Labelled bonds can be a part of the solution as they drive investment inflows toward ESG projects.

Labelled bonds, especially green bonds, have recently received criticism regarding their framework, particularly regarding the real ESG use of proceeds. However, we expect growing standardization and more transparency to help the development of EM ESG sovereign issuance. Labelled bond issuance will not disappear, but the use of proceeds and format standards will be more robust.

Likewise, sovereign SLBs are also a part of the solution, but as they require the global and total engagement of a country, their development will remain focused on IG countries with already good ESG scores. More globally, the labelled bond development will likely remain mainly focused on the IG space.

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