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Sustainability-Linked Bonds Provide Boost For Green Finance

By **Tom Zanki**

Law360 (April 9, 2021, 6:55 PM EDT) -- More U.S. companies are raising money through sustainability-linked bonds, a financing tool that requires businesses to commit to specific environmental goals or face penalties, in an effort to satisfy growing demand for ESG-focused investments.

So-called sustainability-linked bonds began in Europe, encouraged by European Union policy, before the turn of the decade as a means of fighting climate change. These debt instruments are part of a growing mix of investments that address environmental, social or governance — or ESG — principles, adding an alternative to the already booming market of "green bonds."

Now sustainability-linked bonds appear to be taking root in the U.S. At least three domestic companies have raised sustainability-linked bonds, starting with a $900 million debt sale last December by power supplier NRG Energy Inc.

Princeton, New Jersey-based NRG said it was the first energy company outside of Europe to issue an SLB. Chicken producer Pilgrim's Pride Corp. and water infrastructure company Solaris Midstream Holdings LLC also issued sustainability-linked bonds totaling $1 billion and $400 million, respectively, in recent weeks.

Attorneys expect interest in sustainability-linked bonds to grow as companies raise money from institutional investors who are devoting larger chunks of their portfolios to the ESG category, a trend that has been underway for years but has accelerated amid the coronavirus pandemic.

"If this provides another way for companies to access capital and it provides another way for investors who have articulated an ESG mandate to invest in a broader array of companies, then it's a win-win for everybody," Gibson Dunn & Crutcher LLP partner Hillary Holmes said.

Sustainability-linked bonds are designed so that companies commit to concrete goals, such as reducing greenhouse gas emissions by a specified percentage on a certain date. If the company fails to meet that target, it can pay higher interest to bondholders, among other things.

Sustainability-linked bonds differ from more common instruments known as green bonds, whereby a company declares it will spend proceeds on environmentally friendly initiatives, such as installing energy-efficient equipment or investing in renewable technology. SLBs also differ from "sustainability bonds," which are defined by use of proceeds and can be used for environmental or social purposes.

Mayer Brown LLP partner Paul Forrester said sustainability-linked bonds could prove to be durable because they have stronger teeth. If a company fails to meet set targets, it faces tangible costs, and failure to pay up could invite legal action from harmed bondholders.

"The advantage of the sustainability-linked counterpart is there is a real economic consequence: Your interest rate gets changed," Forrester said. "There are actual immediate and demonstrable economic consequences to a company that doesn't perform the way they say."

Characteristics of sustainability-linked bonds vary. As with many green funding instruments, there is no binding legal definition of what constitutes an SLB.

Market participants instead are relying on voluntary guidelines issued last year by the International Capital Markets Association. The Switzerland-based ICMA defines sustainability-linked bonds as "forward-looking" instruments in which companies commit to predefined targets measured through key performance indicators, or KPIs.

The cost of the bond**s** depends on whether a company meets its predefined targets. For instance, NRG pledged a 50% reduction in greenhouse gas emissions by 2025 as part of its $900 million bond issuance. The bonds mature in 2027 and pay 2.45% interest.

If NRG fails to meet that goal, its interest payments will rise 25 basis points to 2.7% effective June 2026, according to the company's U.S. Securities and Exchange Commission filings. The idea behind SLBs is that committing to measurable goals can spur companies to be more ambitious.

The arrival of sustainability-linked bonds follows a **long boom** in financing instruments seen as environmentally friendly. The Climate Bonds Initiative reports that proceeds for green bonds, which were first formed in 2007, peaked at a record $64 billion in the third quarter of 2020.

Ordinary green bonds may appeal to companies because they provide issuers more leeway in determining whether they met their goals, since they are not declaring quantifiable targets.

The flip side is that sustainability-linked bonds provide companies with more flexibility in terms of how proceeds can be used. Issuers can spend money on various business needs, including nonclimate objectives, since they already pledged environmental goals as part of the bond.

"Concrete targets that generate actual positive impact are already baked into the structure of these KPI bonds," Cleary Gottlieb Steen & Hamilton LLP associate Shuangjun Wang said. "That is one of the distinguishing factors and one of the reasons we expect to see a lot more KPI bonds."

Sustainability-linked bonds are still in their infancy and largely untested, making it unclear how investors will react if companies fail to live up to their word. But research firm Moody's Investors Service in a February report predicted that such bonds will "advance significantly" in 2021.

Moody's cited increased government focus on climate change as a reason for expected growth. The financial research company said Europe will likely continue leading this field. The first SLB was issued by Italian energy company Enel SpA, which raised $1.5 billion in September 2019.

Moody's also anticipates the U.S. will commit more resources to sustainable finance under President Joe

Biden, who has recommitted the United States to the Paris climate accords. The SEC has also stated its intent to prod public companies to disclose more about ESG-specific goals, potentially providing a tailwind for green finance.

Lawyers note the coronavirus pandemic has also accelerated interest in corporate finance tied to social goals, including addressing climate change and broader societal objectives. Asset manager BlackRock on Tuesday said it signed a $4.4 billion credit facility with various lenders that is conditioned on hitting staff diversity targets and sustainable business goals or it will pay higher interest.

Forrester said banks for years have issued sustainability-linked loans to clients, which paved the way for corporate interest in similarly structured bonds. The market has now become global.

Sustainability-linked bonds established footing last year in Latin America. Brazilian pulp and paper manufacturer Suzano Papel e Celulose raised $750 million in September, guided by Cleary.

Holmes pointed out that U.S. sustainability-linked bonds have come in varied forms. NRG is an investment-grade company that issued secured notes for its $900 million offering. Solaris, whose bonds are graded as speculative, raised $400 million in unsecured bonds last month.

"That, to me, demonstrates that this is going to be a flexible product," said Holmes, who was part of a Gibson Dunn team that steered the Solaris bond issuance. "Probably more flexible than people thought in terms of the type of issuer who can take advantage of this."

--Editing by Philip Shea and Bruce Goldman.