Fixed Income Commentary | November 2022

MERISTEM

Green, Social, Sustainable, and Sustainability-Linked Bonds

...More Than Just a Bond

Introduction

Background

Following an increasing awareness of global warming and its consequences, several organizations and governments are developing strategies to protect the world's climate. In 2015, all the member states of the United Nations (UN) adopted a 2030 agenda for sustainable development and to confront climate change. At the core of this agenda are the 17 Sustainable Development Goals (SDGs), some of which include the following:

Source: *United Nations, Meristem Research*

The achievement of these goals is hinged on adequate financing, hence the development of targeted investments such as the Green, Social, Sustainable, and Sustainability-Linked (GSSS) bonds.

Trend in GSSS Bonds Issuances

After a UN report linked human actions to climate change, investors began to seek environmentally-friendly projects. The debut financial market offering in this regard was the EUR600mn climate awareness bond issued by the European Investment Bank (EIB) in 2007. Since then, the EIB has issued climate and sustainability awareness bonds totalling about EUR59bn in 22 currencies.

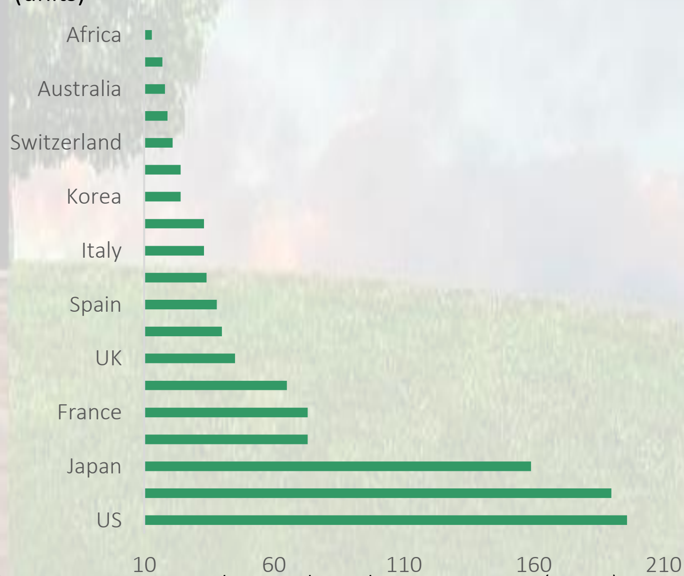
Furthermore, the share of climate and sustainable bonds in EIB's total bond issuances increased from c. 7% to c. 27% between 2019 and 2022.

The World Bank also first tapped into the green bond market in November 2008 raising c. USD440mn. As of 2018, the world bank had raised an equivalent of USD12.6bn through 150 green bonds in 20 currencies.

The popularity of the green bond increased as the International Finance Corporation (IFC) has issued USD10.50bn across 178bonds in 20 currencies as of June 2021.

According to data from the Bank of International Settlements (BIS), the GSSS global market size has increased sporadically by over 1,000% from its value in 2017 to USD2.9trn as of June 2022.

Chart 1: Cumulative issuances of GSSS bonds by countries (units)



Source: *International Capital Market Association (ICMA), Meristem Research*

Introduction

More than just a Bond

GSSS bonds are pivotal to the achievement of a country's sustainable development goals as it poses an opportunity to raise debt at a lower cost. The specific project to be financed determines the classification of the bond. It can be classified into the use of proceeds and sustainability-linked bonds. The use of proceeds implies funding projects that benefit the environment. Sustainability-linked bonds do not directly finance projects but finance the issuer that explicitly has sustainability targets linked to raising the fund.

GSSS Bond Labels

Green Bonds: These are debt securities dedicated to financing projects with positive environmental impacts. The bonds may offer tax incentives to increase its attractiveness. According to the BIS, the green bond is the most issued GSSS bond, representing c.74% of the total GSSS bond issuance. The proceeds from the bond are used to finance projects such as renewables, energy efficiency, waste management, and climate change.

Social Bonds: Proceeds from issuing these instruments are used to finance public and private social outcomes. According to the International Capital Market Association (ICMA), only 134 social bonds have been issued, representing 11.82% of the GSSS bonds issued since inception. Reflecting its increasing popularity, the market size of social bonds has increased from 2.88% of the total GSSS issuances in 2017 to 17.03% in June 2022. The funds are raised for social projects such as disabled people, displaced persons, and COVID-19-related.

Sustainable Bonds are raised to finance a combination of green and social projects. It is the second-highest issued bond after green bonds with 232 bonds issued.

Sustainability-Linked Bonds are linked to the issuer's achievements of SDGs. It encourages organizations to make sustainability commitments and is not as popular as the others, with only 23 issues.

Market Overview and Trends

GSSS Bond Market Overview

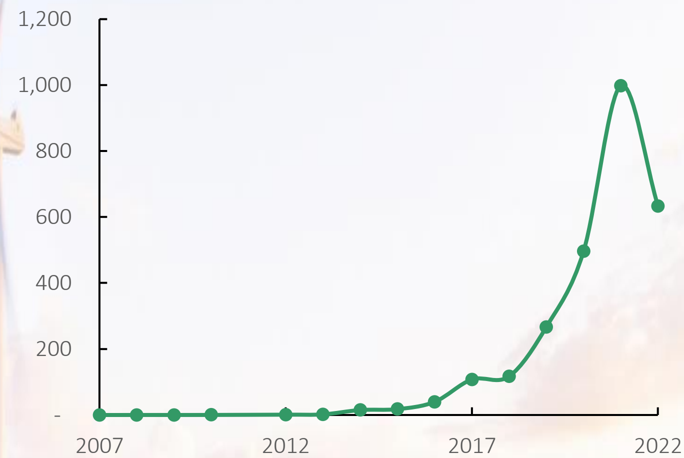
The global GSSS bond market has grown tremendously since its emergence in 2007, with an aggregate issuance value of over USD1.1trn in 2021 according to the World Bank. The cumulative GSSS bond issuance further increased to USD3.3trn in H1:2022. However, the GSSS bond market is still highly untapped, as it accounts for only a paltry 1% of the total assets outstanding and about 2% of new issuances in the global bond market as of December 2021.

The total volume of GSSS bonds issued in H1:2022 declined by 27.00% YoY to USD417.80bn hinged on rising yields and debt market volatility resulting from the Eastern-Europe crisis, which led to a decline in bond issuance. The global GSSS bond Is highly dominated by developed market issuers, who accounted for over 60% of the total issuance in H1:2022.

Emerging markets share have also increased to 29% from 21% in H1:2021. Issuance from supranationals also increased by 75% to USD19.60bn. Among the GSSS bond issuers from 40 countries in H1:2022, China remained the most prominent issuer by volume (22% of the cumulative volume), number of issuers (116), and deal count (190). China's volume issued, deal count and number of issues expanded by 63% YoY, 64% YoY and 59% YoY, respectively, in H1:2022.

This was mainly driven by increased issuances by financial corporates, who account for 55% of the Chinese market.

Chart 2: Annual Issuance of GSSS Bond (USD'bn)



*** As of October 2022*

***Source:** Bloomberg, Meristem Research*

Trends in the Global GSSS Finance Market

- Increasing adoption of European union's taxonomy and Sustainable Finance Disclosure Regulation (SFDR) as more financial institutions seek to show funds' alignment with SFDR.
- Executives upskilling on ESG knowledge due to shareholder's pressure.
- Increasing innovative GSSS financial products e.g., ESG-ETFs, stock exchange listing of themed bonds.

Market Overview and Trends

Overview of GSSS Bond Market in Africa

Africa is faced with climate and social challenges which is exacerbated by the continent's limited ability to manage climate change. This makes the continent prime for investment in GSSS projects to cater for its youthful population. While issuance of GSSS bonds is gaining traction in some African economies, there is a long way to go.

In 2017, Nigeria issued the continent's first sovereign green bond worth NGN10.69bn. The Nigerian Exchange (NGX) established the "sustainable bonds" platform later that year. There are currently four listed sustainable bonds on the NGX (issued by Access Holdings Plc, FGN and NSP-SPV Powercorp Plc). Also, the Lagos state government stated its intention to issue a Green bond of NGN20.00bn before 2022-year end.

Covid-19 pandemic made 2020 a year of influx of GSSS-related activities in Africa: the Johannesburg Stock Exchange launched a sustainable segment for green bonds; Egypt issued its first green bond worth USD750.00mn; the African Development Bank (AfDB) issued a USD3.00bn social bond. Since then, the AfDB has issued various social bonds denominated in Euros and Norwegian Krone. In 2021, Benin republic also issued an SDG Bond of EUR500.00mn.

Despite all this issuances, Africa's total GSSS bond issuance is still less than 1% of the global green bond market.

Outlook For GSSS Bond

Tackling climate change remains one of the pressing issues of our time, requiring investments worth trillions of dollars. This creates a huge window of opportunity for increasing climate-smart investments, which are essential to combating this global challenge. GSSS bonds provide an alluring-investment plan with an opportunity to finance climate-related projects.

In September 2022, the S&P Global Ratings revised its 2022 forecast for global GSSS bond issuance to USD865.00bn (from USD1.50trn in February. This is due to rising interest rates and tightening of financial conditions globally. It is certain that as the proportion of issuers for green, sustainable and sustainability linked projects increase, funding will remain a critical part of executing such projects. Thus, this makes a case for the increased issuance of such bonds in the future.

In Africa, a lot of countries have focused on the local capital market this year due to rising interest rates which has limited access to the international capital market. **The GSSS bond market therefore provides a viable alternative.**

Market Overview and Trends

Outlook For GSSS Bond Cont'd

The international capital market has been receptive of African GSSS bond issuance in the past. We expect this to continue as the size of the global GSSS bond market increases. The following factors are expected to drive the growth of GSSS Bond in Africa;

- **Paris Agreement**: This is a commitment to sustainable investment by African countries. According to AfDB, Africa requires about USD1.6trn investment to implement its contribution to the Paris Agreement by 2030.
- The AfDB has stated its commitment to increase Africa's share of the global climate finance from 3.00% to 10.00% by 2030. This is expected to achieved via initiatives to generate climate financing from outside sources, as well as the climate funds it oversees and to which member nations can submit applications.
- Development of market infrastructures such as sustainable segment and indices on African exchanges will help to facilitate trading of sustainable securities.
- Efforts by African countries to link their public expenditure and investment strategies with Nationally Determined Contributions (NDC) to finance sustainable development projects.
- In a recent survey of over 300 fund managers by the Organization for Economic Co-operation and Development (OECD), c. 56% of respondents indicated interest in sustainable bonds of emerging economies.
- Economic Commission of Africa (ECA) forecasts that Africa needs USD3.00trn to implement Nationally Determined Contributions as agreed upon in the Paris agreement.
- Bloomberg forecast global GSSS Bond issuance to hit USD1.00trn in 2022FY.
- S&P expects 2025 to be a key year for the GSSS Bond market because many issuers have tied their sustainability performance target to it.

Regulations

Overview

GSSS bonds require regulatory bodies to ensure the proper use of proceeds and to increase transparency. As a nascent market, there are still limited protocols and standards. However, the heightened attention in this market has urged certain regulatory bodies to roll out widely accepted standards, albeit voluntary. As such, these principles are set to preserve and promote the credibility of the GSSS market and investors' interests.

International Framework

The International Capital Markets Association (ICMA) sets rules, principles and recommendations to develop the international capital markets. ICMA issued the Green Bond Principles (GBP), Social Bond Principles (SBP), Sustainability Bond Guidelines (SBG), and Sustainability-Linked Bond Principles (SLBP) as voluntary frameworks to promote the role of global debt capital markets in environmental and social sustainability finance. These principles guide issuers on the core components of initiating credible Green, Social, Sustainable, and Sustainability-Linked Bonds. They also assist investors in decision-making and evaluation of the environmental impact of their investments through the promotion of transparency (in the form of relevant disclosures).

ICMA, through these guidelines, highlight the vital openness, precision and reliability of the information disclosed and reported by issuers to stakeholders through core components and critical recommendations. There are four core components for Green, Social, and Sustainable bonds: Use of Proceeds; Process for Project Evaluation and Selection; Management of Proceeds; and Reporting. For Sustainability-Linked Bond Principles, there are five core components: Selection of Key Performance Indicators; Calibration of Sustainability Performance Targets; Bond Characteristics; Reporting; and Verification. In addition, issuers are expected to appropriately disclose the use of proceeds in the legal documentation of the security.

To further promote transparency, it is recommended that issuers appoint an external auditor to assess the compliance of the bond issuance program with the core components highlighted.

Regulations

Domestic Framework

In Nigeria, there are some regulations that have been initiated to provide framework to issuers of green bonds. Specifically, the Federal Ministry of Environment issued the National Green Bond Guidelines and Principles to promote and ensure ease of issuing green bonds in the Nigerian debt market.

Also, the Securities and Exchange Commission (SEC) Nigeria launched rules on the issuance of green bonds in 2018. The primary regulator collaborated with the Climate Bonds Initiative (CBI), the FMDQ OTC Securities Exchange and the Financial Sector Deepening Africa to promote and increase the issuance of private green bonds in the country.

The capital market regulator highlighted the relevant conditions for the approval of a green bond in Nigeria. Below are some of the registration requirements for a green bond issuer in Nigeria:

- A letter declaring the issuer's commitment to invest all the proceeds of the bond in projects that qualify as green project(s).
- A feasibility report stating the measurable benefits of the proposed sustainable project.
- A prospectus which shall include project categories, project selection criteria, decision-making procedures, environmental benefits, use and management of the proceeds.
- An independent external review by a professional approved and/or recognized by the Commission.

Source: *Securities and Exchange Commission, Meristem Research*

Eligible Green Projects

The foundation of a Green Bond is the use of the proceeds for eligible green, social and/or sustainable projects. Therefore, as stipulated by the voluntary principles, it is essential that the project is adequately documented in the framework presented by the issuer(s).

The project(s) must be an asset, investment or expenditure related to one or more environmental objectives.

The following are some of the eligible green projects:

- Renewable energy;
- Energy efficiency;
- Pollution prevention and control (such as air emission reduction; waste reduction, prevention and recycling,; greenhouse gas control);
- Environmentally sustainable management of land use;
- Terrestrial and aquatic biodiversity;
- Clean transportation;
- Sustainable water and wastewater management;
- Climate change adaptation;
- Circular economy adapted products, production technologies and processes;
- Green buildings (certified for environmental performance).

Source: *International Capital Markets Association, Meristem Research*

Issuance of GSSS Bonds

The increased need for countries and corporate bodies to align their operations with the sustainable development goals (SDGs) has equally heightened the need to fund the projects. Due to the capital nature of these projects, the GSSS debt market been the major financing avenue for countries and private institutions to promote and execute the projects.

Like regular bonds, the issuance of a GSSS bond goes through the pre-issuance, issuance, and post-issuance stages. However, there are some additional steps to issue a GSSS bond due to its peculiarities.

The table below highlights the additional steps for issuing a GSSS bond:

Table 1: Regular Bond and GSSS Bond Issuance Processes

Stage	Regular Bond	GSSS Bond (Additional Steps)
PRE-ISSUANCE	▪ Getting a credit rating ▪ Selection of underwriters ▪ Registration with a local regulator ▪ Issuance of prospectus ▪ Due Diligence/Comfort letter	▪ Preparation of a GSSS Bond Framework ▪ Definition of eligibility criteria ▪ Selection of projects and assets criteria ▪ Management of proceeds ▪ Establishment of reporting processes ▪ Pre-issuance external review ▪ Solicit for support mechanisms
ISSUANCE	▪ Book-building interested investors	▪ Inclusion of the GSSS attributes in the marketing
POST-ISSUANCE	▪ Pricing and allocating of bond ▪ Communication with the capital market ▪ Monitor secondary market	▪ Allocation of proceeds ▪ Management of unallocated proceeds ▪ Monitoring the projects ▪ Publication of impact report ▪ Post issuance audit

Benefits to Issuers and Investors

The attractiveness of the market makes it appealing for both issuers and investors to benefit. The GSSS bond market is gaining traction both in Africa and globally. Investors and issuers attuned to ESG investment can leverage this opportunity.

Below are some of the benefits of GSSS bonds to the issuers and investors:

Benefits to Issuers

The high investors' demand presents an alternative source of finance.

It enhances the reputation of the issuer, considering the heightened global interest in sustainable finance.

Offers a competitive advantage as it attracts investors and fosters operational efficiency.

It serves as a long-term financing stream and can support long-term investor loyalty.

Benefits to Investors

An avenue for ESG-conscious investors to directly invest in green and sustainable projects.

Offers increased level of transparency and accountability compared to regular bonds.

It offers competitive returns relative to traditional fixed-income instruments.

Serves as an investment to meet long-term liabilities.

Roles of Meristem

Meristem Capital Limited (MCL)

In our capacity as an investment bank, we can act as an intermediary between bond issuers and interested investors.

Meristem Trustees Limited (MTL)

In our capacity as a trustee, we can provide custodian services. We can preserve and ensure the appropriate use and management of the proceeds.

Meristem Securities Limited (MSL)

The Research unit can carry out extensive study and analysis on prospective investments. This is to give recommendation on their viability and feasibility.

Meristem Wealth Management Limited (MWML)

The team will present the recommended investments to its rich customer base. This is to ensure that interested clients benefit from the investment opportunities.

MERISTEM

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