



Corporate Schuldscheindarlehen – ESG has sustainable impact on Schuldschein market

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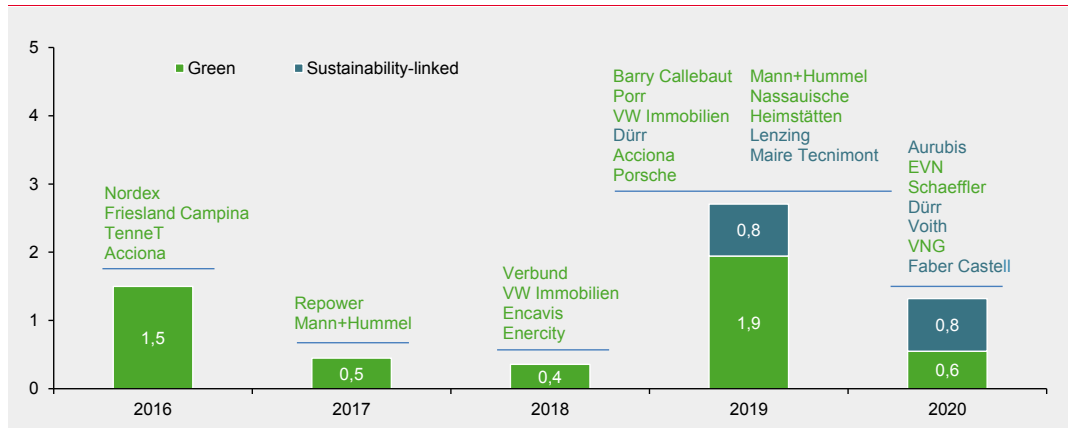
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- The sustainable finance market is growing fast. While the bond market is dominated by green bonds, sustainability-linked issues have become a viable alternative in the Schuldschein-market. Last year, 2.7 billion EUR were issued in both formats which represented roughly 10 % of total issuance. Green Schuldschein accounted for 1.9 billion EUR and sustainability-linked transactions for 0.8 billion EUR.
- Key component of the relatively young finance instrument – also called ESG-linked Schuldschein – is that the coupon is tied to a sustainability performance indicator. The proceeds, however, can be used for general corporate purposes and there is no need to invest them in specific projects with a clear environmental benefit, which is the key requirement for green issues.
- A thorough review of the seven sustainability-linked issues brought to the market so far reveals a clear pattern. Typically issuers chose to tie the interest cost to just one rating which is provided by an established ESG rating agency. Up to now, the coupon step-ups or step-downs observed have ranged from +/-2 to +/-10 basis points which usually represent about 3 % of the base margin.
- Another common feature of green and sustainability-linked transactions is that issuers have to go an extra mile in structuring the transaction – in particular for debut deals. However, leading arrangers on the banking side are fully aware of this and support their clients with dedicated specialists so that this additional effort is reduced to a minimum.

Green und Sustainability-linked Schuldscheine are increasingly popular

Issuance and issuers of green and sustainability-linked Schuldschein (in billion EUR; as of Mai 2020)



Sources: Bloomberg, Helaba Research

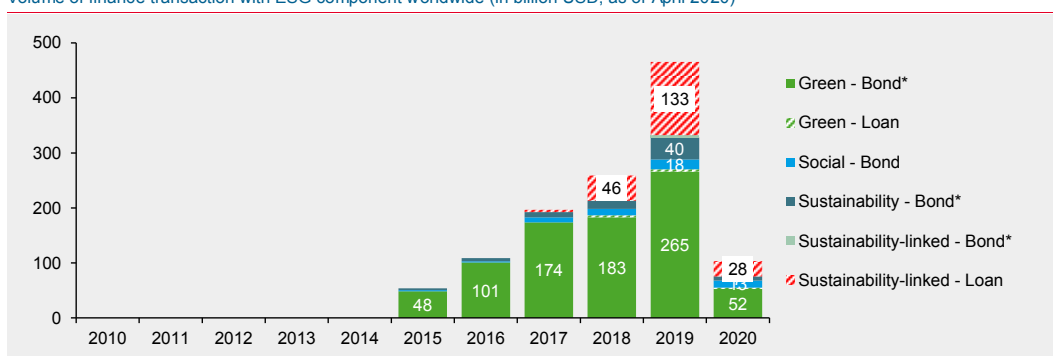
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Sustainable finance is becoming mainstream

The sustainable finance market is growing fast as both investors and issuers show an increasing interest in debt instruments with ESG features. Covid-19 has not stopped this trend. In contrast, we believe that the trend towards a more holistic approach in doing business will provide further tailwind. The bond market has been the starting point of this development, but it is still dominated by green bonds, which require that proceeds are used to finance specific projects or certain project categories that provide a clear environmental benefit. The syndicated loan market has gone another route and favors so called sustainability-linked loans. Key element of these mostly syndicated revolving credit facilities is that the interest margin is tied to one or sometimes more ESG ratings or indicators. Proceeds can, however, be used for general corporate purposes.

Diversity of funding instruments fuels sustainable finance growth

Volume of finance transaction with ESG component worldwide (in billion USD; as of April 2020)



* including Schuldschein
Sources: BloombergNEF, Helaba Research

Schuldschein combines advantages of bond and loan market

While the bond and loan markets show a clear preference for either green or sustainability-linked transactions, both concepts have become an established feature in the Schuldschein market. This gives borrowers two interesting options. Firstly, the green Schuldschein offers financing for smaller projects with a clear environmental benefit through a green issue below the benchmark-size typically required for a bond. Usually such transactions fund investments in renewable energy, electricity networks, energy efficiency, CO₂ reduction or e-mobility. Secondly, the sustainability-linked Schuldschein allows issuers from a wide range of industries to signal the ambition to improve their ESG profile through linking interest costs to a sustainability metric.

Sustainability-linked offers attractive alternative to Green

A key motivation for issuing a green Schuldschein is that it gives companies an ideal platform to present their environmentally friendly business model or investment agenda. The key advantage of the sustainability-linked Schuldschein is its flexibility, because there is no need to invest the proceeds in specific projects. On the other hand, investors know exactly which projects they are financing in the case of a green issue, or that a company is seriously working on the improvement of its ESG profile in case of a sustainability-linked issue. Should the issuer's performance in environmental, social or governance areas deteriorate, investors will receive compensation in form of a higher coupon. These features are becoming increasingly popular, which is also reflected in issuance volume. Last year, green and sustainability-linked Schuldschein amounted to 2.7 billion Euro which represented roughly 10 % of the total market. Thereof, 1.9 billion Euro were green and 0.8 billion Euro sustainability-linked. The biggest deal so far amounted to 1 billion Euro (Porsche) and the smallest amounted to 50 million Euro (Encavis, Repower). This trend has continued in 2020 and we believe that the share of Schuldschein with ESG features is set to rise further in future.

Clear pattern emerges for sustainability-linked issues

The key elements of a sustainability-linked *Schuldschein* are the magnitude of the coupon step-up or step-down, the selection of the sustainability metric and the hurdle rates that trigger a step-up or step-down. A thorough review of the seven transactions brought to market so far reveals a clear pattern in this respect. Typically issuers chose to tie the interest cost to just one rating which is provided by an established ESG rating agency. This is a distinguishing factor compared to the loan market where margin adjustments are often tied to one or several specific ESG metrics (e.g. CO₂ emissions or women in management positions) or a combination of ratings from different agencies. The coupon step-ups or step-downs observed up to now have ranged from +/-2 to +/-10 basis points. This appears to be a rather wide array. However, putting the coupon adjustment in relation to the 5-year tranche shows that it is usually close to 3 % of the base margin. Apparently this is the level both investors and issuers deem to be a reasonable adjustment of the risk-return-profile if the borrower's ESG performance improves or deteriorates significantly. No clear picture has so far evolved with view to the hurdle rates that trigger a margin adjustment. However, this is mostly due to different rating scales and categories used by the agencies.

Recurring key features in sustainability-linked *Schuldschein* become already visible

Sustainability-linked *Schuldschein* transactions

	Dürr	Lenzing	Maire Tecni-mont ⁽¹⁾	Faber-Castell	Voith	Dürr	Aurubis
Issue date	Jun 19	Nov 19	Dec 19	Feb 20	Feb 20	Mar 20	May 20
Issue volume (in million Euro)	200	500	62,5	55	400	115	200
Rating agency	Ecovadis	MSCI	n.a.	IMUG	ISS ESG	Ecovadis	Ecovadis
Rating at close	51	A	n.a.	59	C+	55	68
Step-up rating trigger	40	< A	n.a.	49	< C+	40	56
Step-down rating trigger	62	> A	n.a.	69	> C+	62	80
Margin step-up/down (in bp.)	+/- 2	+/- 2.5	+/- 10	+/- 2	+/- 2.5	+/- 2	+/- 5
Margin step-up/down (in % of base-margin) ⁽²⁾	2.0%	2.9%	4.3%	3.1%	3.3%	3.1%	3.1%

(1) Interest tied to CO₂ reduction; (2) in relation to 5-year tranche (assumption: pricing at low end of marketing range)

Sources: Bloomberg, Helaba Research

Arranging banks minimize extra effort for issuers

Another common feature of green and sustainability-linked issues is that issuers have to go an extra mile in structuring the transaction – in particular for debut deals. For instance, green issues require companies to provide a Green Finance Framework that explains topics such as the types of projects that shall be funded and how the issuer intends to report on the allocation of proceeds. Moreover, it has become market standard to verify the greenness of an issue by an independent agency through a so-called second party opinion or SPO. In the case of sustainability-linked transaction the ESG rating takes center stage. While large and publicly listed companies can often build on an existing rating, smaller or privately owned issuers first need to mandate an agency. For both services – SPO and ESG rating – a handful of agencies is emerging as established players. However, there is certainly no one-size-fits-all. Rating methodologies and costs differ widely. In this respect arranging banks can provide substantial value-added by helping to draft the Green Finance Framework, finding the right agency and actively supporting the SPO or rating process. Leading arrangers are fully aware of this and support their clients with dedicated specialists so that their additional effort is reduced to a minimum.

Leading providers of second party opinions and ESG-ratings

Key data

	Sustain- alytics	ISS ESG ⁽¹⁾	VigeoEiris / IMUG ⁽²⁾	CICERO	Ecovadis	MSCI	S&P
Second Party Opinion	✓	✓	✓	✓	✗	✗	✓
ESG-rating	✓	✓	✓	✓	✓	✓	✓
Head office	Amsterdam (NL)	Rockville (US)	Bagnolet (F) / Hannover	Oslo (NOR)	Paris (F)	New York (US)	New York (US)
Ownership	Morn- ingstar ⁽³⁾	Genstar Capital ⁽⁴⁾	69% Moody's ⁽³⁾	Foundation of State of Norway	Manage- ment, pri- vate equity	Publicly listed	Publicly listed

(1) Takeover of oekom in 2018, (2) IMUG is the German network partner of VigeoEiris; (3) publicly listed; (4) private equity

Sources: Company information, Helaba Research ■