focus

Lending with **Purpose**

Last month Precinct Properties issued the latest "Green bond" in the New Zealand fixed income market. Precinct joins a growing list of companies that have opted for this relatively new type of financing.

In this article we unpack some key issues around the increasingly common issuance of Green, Social, and Sustainability (GSS) bonds and how they can help investors incorporate responsible investment, sustainability, and Environmental, Social and Governance (ESG) objectives into their fixed income portfolios.

FORSYTH BARR

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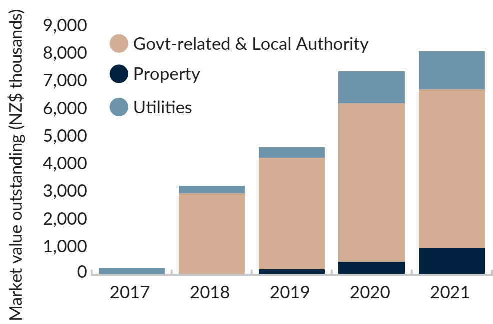
Incorporating responsible investment, sustainability, and ESG into portfolios is an increasing focus for investors, both globally and in New Zealand. These trends are not only important for equity investors; they are increasingly relevant to fixed income investors too. As is typical in the investment world there is a proliferation of jargon with recent issues in New Zealand being labelled as “Green”, “Sustainability” and “Wellbeing” bonds. At the crux of it, the money from GSS bonds will all go towards projects that contribute to positive environmental, social, and/or sustainability outcomes – hence the term ‘Green, Social and Sustainability’ (GSS) bonds to encompass them all.

Market growing at rapid pace

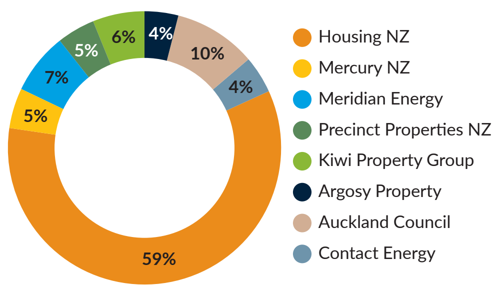
The market value of GSS bonds on issue in New Zealand has increased from being relatively small (around $NZ250 million in 2017) to a respectable level of around $NZ8.2 billion today. This increase has been led by Government-related entities, with Auckland Council’s Green bonds and Housing NZ’s (Kāinga Ora) Wellbeing bond programme combined representing ~71% of the current market. Currently three Property companies, Argosy Property, Kiwi Property Group and Precinct Properties and three of the electricity ‘gentailers’, Contact Energy, Mercury Energy and Meridian Energy also have GSS bonds on issue.

GSS BOND MARKET IN NEW ZEALAND



Source: Refinitiv, Company reports, Forsyth Barr analysis

CURRENT GSS BOND ISSUERS IN NEW ZEALAND, AMOUNTS ON ISSUE



Source: Refinitiv, Forsyth Barr analysis

...Housing NZ's Wellbeing bonds finance affordable housing...

How they work

There are two broad types of GSS bond: 'Use of Proceeds' bonds and 'Sustainability-linked' bonds. All of the GSS bonds currently on issue in New Zealand are 'use of proceeds' bonds where funds raised are directed towards specific projects which have a positive social or environmental benefit. For example, Housing NZ's Wellbeing bonds finance affordable housing, waste reduction initiatives and a service to provide support to the organisation's most vulnerable customers, while Argosy uses the proceeds from its Green Bonds to finance or refinance a number of its buildings which have been independently rated as sustainable or 'green'.

In contrast to 'use of proceeds' bonds, 'sustainability-linked' bonds do not finance particular projects but rather the general activities of an issuer. Importantly, 'sustainability-linked' bonds are structurally linked to the issuer's achievement of environmental or social goals. For example, in 2019 Italian power company Enel issued a sustainability-linked bond to support its goal of lifting its renewable generation to 55% of its total power generation capacity by 2021. If it fails to do so the bond's coupon will increase by 25 basis points, providing an incentive for the company's move to renewable power.

It is possible we may see sustainability-linked bonds in the New Zealand market in the future, with Auckland Council's Sustainable Finance Framework stating an intention to raise capital via that avenue.

A Green bond is not necessarily a 'green tick'

Issuing a GSS bond does not mean the company as a whole is environmentally or socially friendly; a high-emitting company can issue a Green bond just as a low-emitting company can. What it can mean, in the case of 'Use of Proceeds' bonds, is that the investment proceeds will go towards projects that have been independently verified to have positive environmental or social outcomes. Buyer beware, it is not compulsory for an issuer to have its use of proceeds independently verified, although as far as we are aware all New Zealand issuers have done so.

New risks on the table

New financial instruments bring with them new risks and GSS bonds are no different. The added risk of a GSS bond is that sometime after purchase it may cease to meet its Green, Social, or Sustainability criteria with no associated penalty for the issuer. In this situation investors may find themselves holding a security that is difficult to sell and/or no longer fulfils the role in the portfolio they purchased it for.

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Place in a portfolio

With the GSS bond market in New Zealand in its infancy there is not yet any observable difference in yield or return between GSS bonds and similar traditional bonds. International research has found little evidence of this either, with one 2020 study of the Hong Kong Green bond market finding a very modest average premium (or "Greenium") of -1.2bps. Despite this, investors can have motivations other than financial returns for holding GSS bonds, such as meeting a Responsible Investment mandate or to align with their values.

With global trends in responsible investment, sustainability, and ESG accelerating at a rapid pace, GSS bonds are one of the few tools only available to fixed income investors, an investor group that has previously lagged when it comes to ESG options. An understanding of the specific features and risks of these bonds will enable investors to decide what place, if any, they may have in their portfolios.

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Understanding that sudden changes in financial markets can cause concern or indicate opportunity, your Forsyth Barr Investment Adviser is available to provide you with advice and assistance at any time.

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