Why sustainable Bonds (should) yield lower

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The enormous rise of the segment of sustainable debt instruments has inevitably raised a fundamental question: are sustainable debt instruments from an issuer's point of view cheaper, more expensive or does the question of sustainability not play any role in terms of interest rates? A look at the empirical evidence of the debt capital markets has so far shown that “green” and “gray” bonds show no significant difference with regard to the issuing yield. However, there have been some large sustainable transactions over the last few months, e.g. by German carmaker, which – measured against their secondary market curve determined by outstanding gray bonds – could be placed well below this issuer’s secondary market curve and thus led to significant advantages in terms of financing conditions for issuing companies.

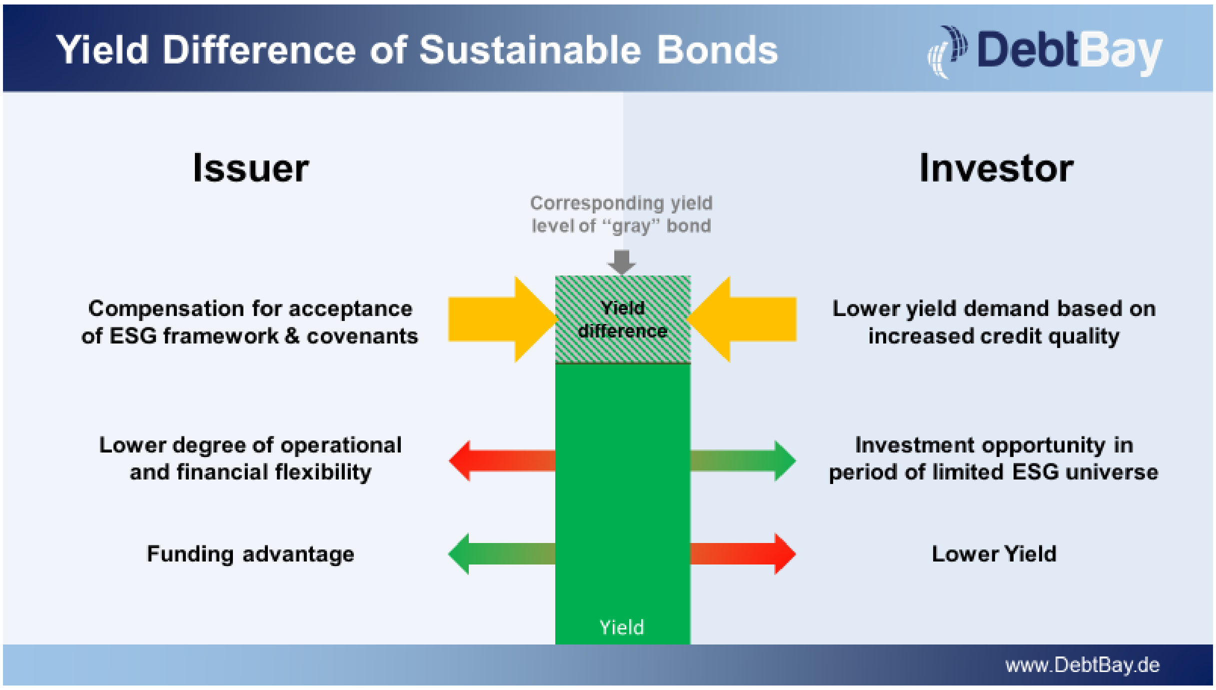
While empirical observations have only shown a certain tendency it is also worthwhile to appreciate theoretical considerations in this regard. There are at least four strong arguments indicating sustainable debt instruments as advantageous funding source over their “gray” alternatives from an issuer’s point of view:

At first, a company has to full fill certain requirements to issue a bond which is qualified as sustainable under the taxonomy regime. Specific elements of this regulation limit the issuer in it’s future financial and even more in it’s operational flexibility, e.g. by specific carbon targets. All in all a sustainable debt instrument means less flexibility for an issuer compared to a classic “gray” bond. A rational issuer therefore demands something in exchange which are better financing conditions in terms of lower company specific interest rates (Spreads).

Second, the taxonomy regime under which sustainable bonds are issued has beyond social goals an important business aspect as well: an issuer shall be tied to specific ESG aspects in order to provide that the issuer will make it better trough the necessary ESG related transformational process ahead. It is precisely for this reason that rating agencies are increasingly integrating ESG aspects as well into their methodology when analyzing credit quality. This philosophy leads to a lower predicted probability of default lowering the risk assessment of (potential) investors. Subsequently yield demanded by credit investors decreases leading to better specific financing conditions for issuers of ESG related debt.

Thirdly, enormous inflows of ESG dedicated money can currently be observed at the buy side, investment demand which is still meeting a very limited supply of fitting sustainable debt instruments. The investment opportunities in the sustainable universe are still very limited, both in terms of volume and the diversity of issuers. Currently this segment is still heavily dominated by a few industries, mainly utilities, public agencies and real estate. Based on the basic law of supply and demand, this fact leads to enormous pressure on the issuing yields of bonds as many investors are willing to accept lower yields considering the lack of alternatives. Issuers can take advantage of environment described provided that the optimization of the issue interest rate is a core objective of a company’s funding policy.

Fourth, the most efficient funding of an issuer itself represents a value. Only the most efficient way of funding ensures that the management makes sustainable use of the owners' capital. The optimization of the financing costs is therefore part of Governance itself. For this reason, the area of Capital Governance, which is dealing with an appropriate capital structure and efficient funding strategies, is becoming increasingly important. Sustainable debt instruments are a key element of realizing Capital Governance which can be realized to a large extent through the advantages of sustainable debt instruments. For this reason, sustainable debt instruments are a core component of Capital Governance.



In summary it can be stated that sustainable debt instruments have an advantage in the area of funding for various reasons. This advantage is reflected in lower company specific interest rates and subsequently in better financial results driving share-holder-value. The key result of sustainable finance, lower interest rates, is in turn a core goal of Capital Governance, a rapidly developing sub-area of Corporate Governance.

In this regard it must be noted that an issuer may only access the potential of sustainable finance if this is based on a concrete, operational basis and the management is also fully committed to the ESG goals communicated. Investors would quickly recognize that the advantages of sustainable finance were only used for the purpose of realizing funding advantages and creating an (non-sustainable) gain in share-holder-value. The consequence would be a considerable loss of reputation, which would have a lasting negative effect on possibilities of funding as well as on the operational business for years to come.