Operators that set ambitious KPIs will be better placed to gain capital from sustainability-linked finance

August 2024

Grace Langham

Sustainable finance will play a crucial role in achieving global net-zero goals, as confirmed by the UN's climate change conference (COP28) in November 2023. Sustainable finance is designed to support long-term financial growth through investments that benefit and promote environmental and social objectives. According to the Glasgow Financial Alliance for Net Zero (GFANZ), an estimated USD125 trillion is needed globally to support the scale up of low-carbon solutions to reach net-zero by 2050 and companies across many industries, including the telecoms sector, are turning to sustainable finance options to help them to fund their net-zero projects. Some options include: green, social and transition bonds (Figure 1), and loans. This article explores how telecoms companies are embracing a specific type of sustainable finance: sustainability-linked bonds (SLBs).

***Figure 1:** An overview of the sustainable bond options that are available to businesses*

Name of bond	Description
Sustainability-linked	The issuer commits to future improvements in sustainability KPIs within a pre-defined timeline
Green	The proceeds are exclusively applied to finance pre-identified projects with clear environmental benefits
Sustainability	The proceeds are exclusively applied to finance a combination of green and social projects
Transition	The issuer must use the proceeds to support the process of transitioning to lower carbon operations
Social	The proceeds are exclusively applied to finance in part or in full new and/or existing eligible social projects

Source: Analysys Mason

Sustainability-linked finance options require the borrower to meet environmental key performance indicator (KPI) targets, can mean higher interest rates if those goals are not met, and so can help to ensure that operators commit to meeting their sustainability-related promises. However concerns linger, from investors, about the lack of stringency of the goals set by organisations that are issuing the bonds. Hence, operators that set ambitious and diverse sustainability-linked KPIs are likely to better placed to access SLB capital in the future.

SLBs can hold companies accountable for their environmental performance

Many investors are increasingly incorporating ESG factors into their investment decisions, making the sustainable bond market an attractive option for those seeking to align their portfolios with sustainability goals. In addition, issuers of sustainable bond options can attract a new pool of ESG-focused investors, and hence open up new sources of finance. In terms of financial returns, sustainability-linked bonds generally offer yields similar to those of traditional bonds with similar credit ratings, maturity periods and risk profiles. The major pull for the sustainable bond market is the ability for issuers to showcase their commitment to ESG responsibilities while also gaining access to capital.

Sustainability-linked bonds are a recent innovation, with the first issuance by Italian utility and telecoms company, Enel in 2019. SLBs tie borrowing costs to pre-defined KPIs, which are assessed against certain sustainability performance targets (SPTs). This incentivises companies to invest in energy efficiency, renewable energy and waste reduction. The International Capital Market Association (ICMA) developed the Sustainability-Linked Bond Principles (SLBP) June 2020, which includes a set of guidelines to help issuers set credible SLBs and supports investors by ensuring issuers have provided the necessary information to evaluate their SLB investment.

Failure to meet SLB targets can result in financial consequences like reputational risk (resulting in weaker share prices), higher interest rates, mandatory repayments, or even conversion of the bond into equity. In 2023, Enel missed its Scope 1 carbon intensity target linked to 10 bonds worth a total of USD11 billion. The coupon increase on these bonds was 0.25% and as a result the increase in interest cost amounts to USD89 million over the remaining life of these bonds.

Figure 2: General criteria of sustainability-linked bonds

Lenders	Funds typically come from investors such as asset managers and insurance companies.
Use of proceeds	The raised funds can be used for general corporate purposes, but the company is financially motivated to improve its sustainability performance.
KPI commitments and reporting	Issuers hold the primary responsibility for setting the KPIs (supported by the guidelines set by the ICMA). The ambition of the KPI should be embedded in a long-term strategy approach rather than focusing on short-term deliverables. According to the ICMA guidelines, companies must commit to regularly reporting on the KPI progress in their annual sustainability reports.
Interest rates	Interest rates are not fixed in the way that traditional bonds are. They are influenced by the issuer's performance against its pre-defined sustainability performance targets.
Failure to meet KPIs	Failure to meet targets could lead to higher interest rates, reputational damage and mandatory repayments.

Source: Analysys Mason

Several European telecoms operators have issued SLBs

A number of European telecoms operators are exploring SLBs (and are following the SLBP guidance) as they navigate stricter regulation and public pressure to bring their emissions and energy consumption down. Examples include the following.

- **KPN** issued its first SLB in November 2021, amounting to EUR700 million, as part of its goal to achieve net-zero emissions by 2040. If KPN does not achieve its emission reduction targets by 2030, the interest rate of the bond will increase by 0.375% annually. As part of its SLB, KPN has committed to reduce its Scope 3 emissions by 30% by 2030 (compared to 2014). KPN reported that the bond was well received by Socially Responsible Investors (SRIs), allowing KPN to diversify its investor base and further optimise its funding structure. By 2023, KPN had reduced its Scope 3 emissions by 30%, meeting its SLB target.

- **Orange** completed its first sustainability-linked bond issuance for EUR500m in September 2023. The bond is linked to the company's target to reduce its absolute GHG emissions (Scope 1, 2 and 3) by 45% by 2030 (compared to 2020 levels).

- **TDC Net** issued a EUR500 million SLB in April 2024, under the terms of which the company has committed to meeting net-zero goals across its Scope 1 and 2 emissions by 2028. It also aims to reduce its Scope 3 emissions by 40% by 2030. If TDC does not achieve its emission reduction targets by 2029, the interest rate of the bond will increase by 5.186% annually.

The ambition of sustainability-linked KPIs are a point of debate

A critical question for the success of SLBs is whether companies are imposing sufficient penalties for non-compliance and setting sufficiently ambitious targets. This concern is underscored by instances where companies such as Enel are incurring higher interest costs due to failing to meet their predefined targets (as the penalties are often low) or companies (such as designer retailer Chanel) are already achieving their targets by the time the bond is issued or KPN which met its SLB targets 7 years before the deadline. This has led to many investors becoming increasingly sceptical of SLBs. Currently, all guidelines for SLBs are voluntary, leaving it largely to investors to determine their satisfaction with the bond terms. Investors are likely to be more attracted to companies that set challenging sustainability goals. SLBs that feature a diverse range of KPIs demonstrate greater transparency and may better align with the specific sustainability objectives and focus areas of a wider array of investors. Although this approach carries a higher risk of non-compliance, companies that successfully achieve more ambitious targets could be in a good position to access even more capital in the future.