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Amundi ASSET MANAGEMENT

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Responsible investing expands further with green convertible bonds

Convertible bonds go green

While investors have been aware of the merits of investing responsibly for a long time, the Covid-19 crisis is likely to increase the focus on ESG principles, which should play a critical role in the emergence from the crisis. In this context, green bond financing has recently spilled over to convertible bonds, with **2020 seeing a record level of new issuance for the asset class.** Convertible bonds -- which are corporate bonds that can be converted by the holder into the common stock of the issuing company -- have proved resilient during the Covid-19 crisis. Such resilience, along with a record level of new issuance -- above $100bn YTD -- has sparked renewed interest in the asset class. Interestingly, for investors and corporates alike, issuance of green convertible bonds is also on the rise. Before 2020, only two green convertible bonds were issued – namely, Sumitomo Forestry (Japan) in 2018 and Link REIT (Hong Kong) in 2019.

"Convertible bonds have proved resilient during the Covid-19 crisis and -- along with a record level of new issuance -- have sparked renewed interest in the asset class".

Since May 2020, nine companies have issued green convertible bonds, including Neoen on 28 May, with the first European green convertible bond for €170m. Neoen is a renewable energy company that builds and manages power plants in solar, wind and biomass. Proceeds from its green convertible bonds will be allocated to finance or refinance renewable energy production and storage activities consistent with EU requirements. This was followed by Électricité de France (EDF), which sold a historic €2.4bn green convertible bond on 8 September. **This sale was significant in terms of the sheer size of the deal and marks another step in the spread of socially responsible investing to convertible bonds.** EDF plans to use the proceeds from this bond to double net installed renewable energy capacity over the next ten years. Although technically not a 'green' bond, it is interesting to note that Schneider Electric launched the first sustainability-linked convertible bond in November which links the performance to three KPIs (CO2 emissions, gender diversity, and number of underprivileged people trained in energy management) to the cost of the coupon paid to investors.

Table 1. Green convertible bonds issued

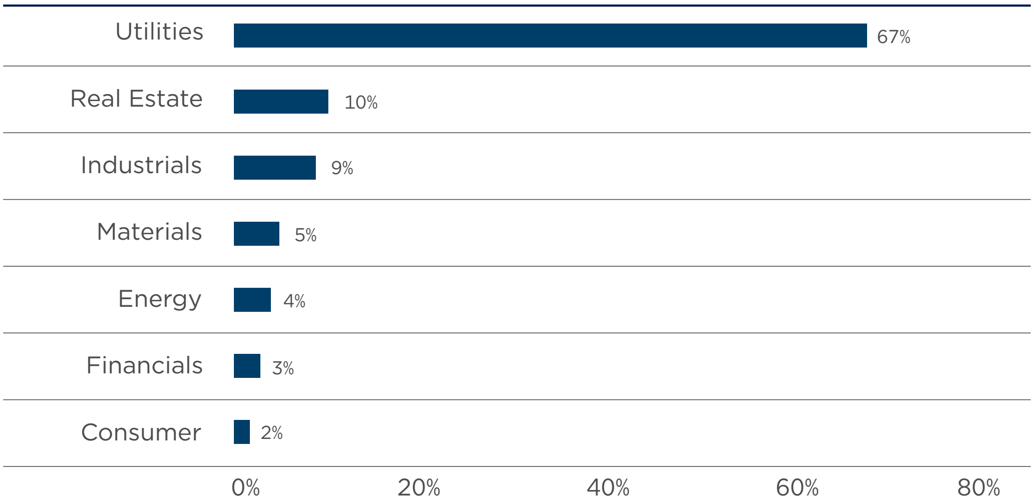
Issue date	Issuer and maturity	Issue amount, mn	Region	Sector
11 Sep 2018	Sumitomo Forestry, 2023	10,000 JPY	Japan	Consumer
7 March 2019	Link REIT, 2024	4,000 HKD	Asia	Real estate
14 May 2020	Plug Power, 2025	212 USD	United States	Industrials
28 May 2020	Neoen, 2025	170 EUR	Europe	Utilities
23 June 2020	Livent, 2025	246 USD	United States	Materials
10 July 2020	Maxeon Solar Tech, 2025	200 USD	United States	Energy
16 July 2020	Atlantica Jersey Limited, 2025	115 USD	United States	Utilities
7 Aug 2020	Bloom Energy Corp, 2025	230 USD	United States	Industrials
19 Aug 2020	Hannon Armstrong Sustain, 2023	144 USD	United States	Financials
8 Sep 2020	EDF, 2024	2,400 EUR	Europe	Utilities
16 Sep 2020	Falck Renewables, 2025	200 USD	Europe	Utilities

Source: Amundi, Bloomberg. Data as of 16 November 2020.

"Given their natural exposure to green assets, the utilities, banking and real estate sectors have been by far the most active in the green bond space, accounting for some 90% of green, social and sustainability bond corporate issuance in 2018".

While issues in Europe have been focused on the utilities sector, US issues have been more diversified, ranging across the industrials, materials, energy and financials sectors. Plug Power -- a provider of hydrogen fuel cell technology -- issued a first green convertible bond in May 2020, followed by five additional US issues through August. The net proceeds from Plug Power's convertible green bond offering will fund -- among other things -- strategic initiatives that underpin the company's green hydrogen strategy.

Figure 1. Leading sectors in green convertible bonds



Source: Amundi, Bloomberg. Data as of 4 November 2020.

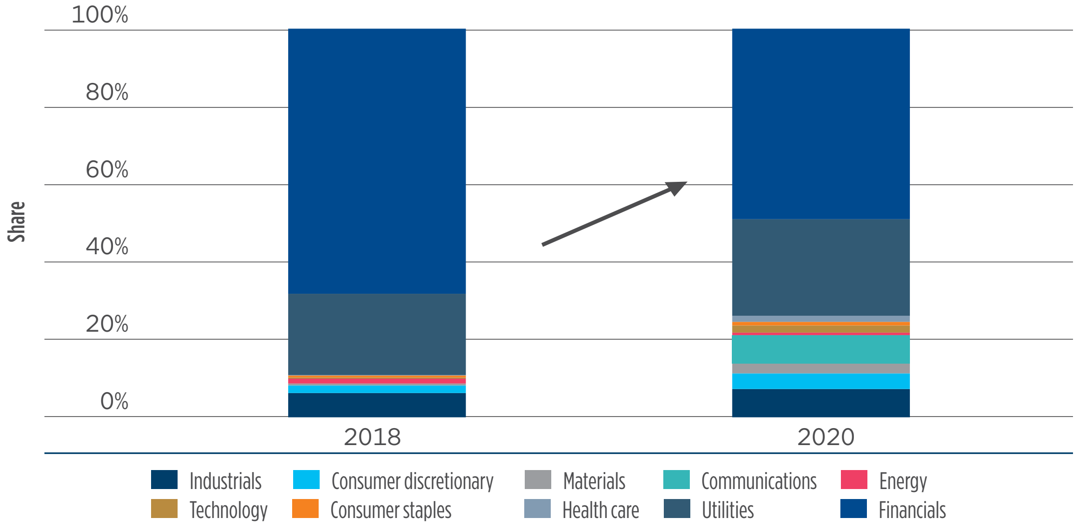
Green convertible bonds through the lens of the Green Bond Principles

Although green convertible bonds are not specifically mentioned in the latest edition of the [Green Bond Principles] (GBP, 2018), we believe that GBPs fit well this hybrid security, at least during the bond life of the instrument. The conversion from bond to stock brings some specificities that require a few upfront clarifications from an issuer on what it plans regarding the allocation of the proceeds. We discuss some of these specificities through the four core components of the GBP.

1. Use of proceeds

Issuers of green debt must commit to allocating the proceeds to a pre-determined list of project categories that have positive environmental impacts. **Given their natural exposure to green assets, the utilities, banking and real estate sectors have been by far the most active in the green bond space, accounting for some 90% of green, social and sustainability bond corporate issuance in 2018.** Over the past couple of years, sector diversification has improved among issuers, but these sectors still account for the largest share of issues.

Figure 2. Increasing sector diversification of green, social and sustainable bond issuers



Source: BNEF, Amundi. Data as of 16 November 2020.

"We see some potential for a take-off of green and sustainability convertible bonds".

Admittedly, these sectors are less represented in the convertible bond space than in an investment-grade corporate credit index. Nonetheless, **we see some potential for a take-off of green and sustainability convertible bonds.** Indeed, some sectors that are particularly active in issuing convertible bonds have been playing an increasing role recently. For instance, the technology sector has been using green-labelled debt to finance its contribution to the development of renewable energies and energy-efficient data centres. Within the consumer discretionary sector, the auto industry has plenty of potential to use green debt to finance the development of electric vehicle offerings.

2. Process for project evaluation and selection

On this pillar, we do not see any specificities attached to convertible bonds. As for any green bond, it is key to stay vigilant on:

- the proper management of environmental and social risks attached to the financed green projects to avoid any reputational risk; and
- the financing of projects that will contribute directly to an ambitious wider environmental strategy for the issuer.

3. Management of proceeds

A commitment by the issuer to track the proceeds and their allocation to targeted projects over the lifetime of the bond is another core component of the GBP. **For green convertible bond issuers, this requires clarification on how this will be managed when the bond converts.** For instance, Link REIT specifies that in the event the bond converts before the allocation is completed it *"will continue the commitment to allocate an amount equal to the net proceeds as soon as practicable but no later than the original maturity date of the convertible bond"*. This is an important clarification, as it provides certainty to the investor that the issuer intends to allocate 100% of the proceeds raised, hence maximising the positive impact.

"Issuers of green convertibles should report on the environmental impacts of the projects financed, based on quantitative metrics whenever possible".

4. Reporting

Just like straight green bonds, **issuers of green convertibles should report on the environmental impacts of the projects financed, based on quantitative metrics whenever possible.** Sumitomo Forestry delivered on this promise with dedicated reporting. For investors willing to report on the impact of the assets financed by a fund, green convertible bonds bring a specificity. In our view, although the positive environmental impacts of projects are meant to remain in place over the life time of a project, the traceability is lost as soon as the bond converts to equity shares as, contrary to bonds, shares cannot be singled out by a specific identification number. This specific conceptual issue in terms of 'attribution' of the positive impacts at the fund level is nonetheless limited to the extent that convertible bond funds do not stay invested in shares.

Table 2. An example of impact reporting: Sumitomo Forestry

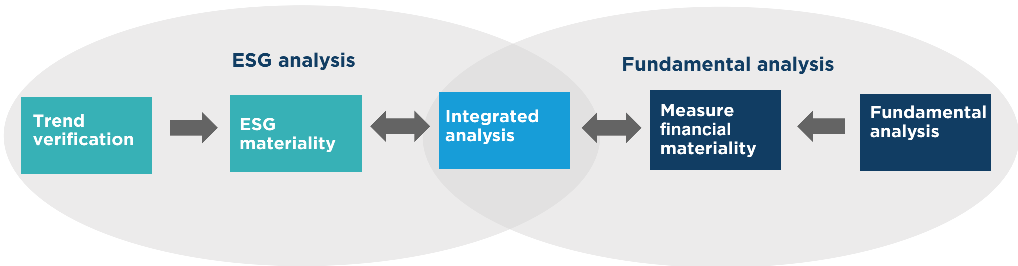
Total size of the forest area	36,360 Ha
Harvested area	753 Ha
Replanted area	668 Ha
Certified area	36,360 Ha
Total sustainable wood/timber production volume	421,093 Ha
Carbon stocks in net CO_2 amount	4,777,000 t-CO_2

Source: Sumitomo Forestry, Amundi. Data as of 5 November 2020.

Opportunities from green convertible bonds for fundamental investors

Active investors who look to generate excess returns can participate in the green convertible bond market with the goal of improving alpha generation. **Green convertible bonds are analysed using a combination of ESG and fundamental analysis of the credit, equity and technical features of the convertible bond.** A combination of ESG and fundamental analysis can help assess the sustainability and profitability of each corporate's business. Moreover, **it is key to monitor other considerations, including the use of proceeds, liquidity, and other potential risk elements.**

Figure 3. Integrating ESG and fundamental analysis



Source: Amundi as of 16 November 2020.

"A combination of ESG and fundamental analysis can help assess the sustainability and profitability of each corporate's business".

Green convertible bonds are a source of growth and innovation in the convertible bond primary market, which has been particularly active this year. While green convertible bond issuance has reached nearly $5bn in total, this still represents less than 5% of total new issues of 2020 and thus has room to grow. Deal terms have mostly been in line with the pricing of comparable non-green deals, although deals from European issuers have tended to be more aggressive, according to BofA Research. Some advantages mentioned by issuing companies are that the **process of issuing a green convertible bond is flexible, easy to use and not expensive,** particularly in Europe, where the demand for green bonds is higher among investors.

It is also important to highlight some of the **risks of investing in green convertible bonds given the newness of this market:**

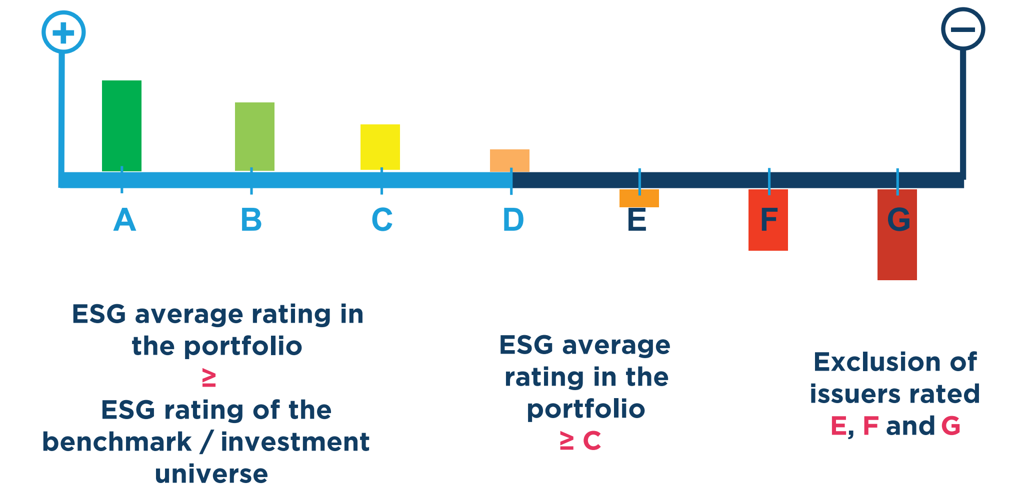
- One of the risks is a **potential lack of liquidity.** Being a small and nascent market, entering and exiting positions may not be as easy as for other more traditional issues. For the same reason, there is less choice among issuers or sectors which could limit bottom-up picking opportunities.
- Another risk is the **lack of a clear definition of a green bond.** So, investors have to rely on a company's word that it will abide by its stated intention for spending the proceeds, as outlined in the corporate documents.

- A final area of risk to monitor is **valuation.** Given increased flows into ESG and sustainable investments, and a relatively limited choice of issuers to date, it is important to ensure that valuation is in line with company fundamentals.

In light of these risks and opportunities, investors can adopt two investment approaches to integrate ESG into convertible bond investing -- namely, a '**best-in-class**' and an '**ESG improvers**' approach to ESG investing.

The **'best-in-class'** approach includes only the **better ESG-rated companies** and excludes those that fall in the bottom categories. Having an average ESG fund rating higher than the benchmark may be a goal within such an approach. Active engagement with corporate management on ESG issues is key in light of the relevance of ESG principles to the convertible bond investment process. While useful, such an approach may be too static, however, and lead investors to engage only with **ESG leaders** that are quality companies with attractive valuations and strong ESG ratings, regarding which the premium is already priced in.

Figure 4. 'Best-in-class' SRI approach based on four rules



Source: Amundi as of 27 November 2020. **For illustrative purposes only**, may change without prior notice.

"The 'ESG improver' approach is more dynamic and forward-looking and based on detecting those opportunities where the ESG premium is not yet priced in fully, seeking future ESG leaders".

On the other hand, the **'ESG improver'** approach is more dynamic and forward-looking, and is based on detecting those opportunities where the ESG premium is not yet priced in fully, seeking future ESG leaders. **Such an approach prioritises the point where an ESG improvement has the largest impact on performance.** Since ESG implementation tends to be a slow-moving dynamic, it is possible for investors to extract value from companies that are embarking on an ESG-improvement journey. For more details, please see our recent publication on this topic.

Conclusions

The most important issue in this context is the overall direction of travel – that is, the desire for investors and companies alike to combine higher transparency and sustainability goals alongside financial performance. **There is over $1tn of green, social and sustainability-linked bonds outstanding today, and this is expected to increase significantly over time.** In particular, sustainability-linked bonds have strong potential to thrive in the convertible space. The extension of responsible investing to convertible bonds means that investors are increasingly expecting to see **additional information on project financing, regular monitoring, and ongoing impact reporting after the issue takes place.** All of these elements are positives for the asset class and for responsible investing. Nonetheless, investors need to consider carefully the risks and opportunities for alpha generation in addition to higher transparency and a company's sustainability goals when making an investment. More generally, as the Covid-19 pandemic has accelerated the trend towards ESG investing, active asset managers with proven ESG expertise and proprietary research capabilities will play a key role in identifying investment opportunities.

Definitions

- **Alpha:** The additional return above the expected return of the beta-adjusted market return; a positive alpha suggests risk-adjusted value is added by the money manager compared with the index.
- **Bond ratings:** If the ratings provided by Moody's and S&P for a security differ, the higher of the two ratings is used. Bond ratings are ordered highest to lowest in a portfolio. Based on S&P's measures: AAA (highest possible rating) through BBB are considered investment grade; BB or lower ratings are considered non-investment grade. Cash equivalents and some bonds may not be rated.
- **Diversification:** Diversification is a strategy that mixes a variety of investments within a portfolio in an attempt to limit exposure to any single asset or risk.
- **KPIs:** Key performance indicators.

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