

Calvert's Approach to Investing in the Green Hybrid Bond Market for European Utilities



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Utilities are a capital expenditure (CapEx) -heavy industry due in part to the investment required to develop renewable energy generation capabilities whilst strengthening transmission and distribution infrastructure. Much of the CapEx focused on supporting these efforts is considered 'green' by many market participants due to its facilitation of the energy transition and its alignment to credible taxonomies for defining sustainable investments. Utilities tend to rely extensively on debt issuance for their financing needs, and in Europe the green hybrid bond format has become an increasingly popular tool for these issuers to support growing CapEx programs as the region increases its climate ambitions. In order to leverage the full potential of these instruments, and to facilitate investor tracking of their sustainability benefits, it is important these issuers adhere to best practices, including transparency around underlying projects financed through these green hybrid programs.

Through the identification of best practices in green hybrid bonds, Calvert aims to ensure that our evaluation process is cognizant of the complexities of this instrument, with sufficient leeway to appreciate the nuances that a specific issuer and transaction may have. By doing this, we seek to realise the opportunities that the green hybrid market provides to investors in terms of financing utilities' green CapEx, allowing us to help facilitate the sector's energy transition.

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Merits of the Hybrid Structure

Hybrid bonds are a subordinated¹ financial instrument that have both bond and equity features, with an initial fixed coupon and the ability of the issuer to defer coupon payments and convert the principal to common equity. A green hybrid bond combines these features with those of a labelled green bond, allocating the specified use of proceeds raised through the transaction to finance environmentally beneficial projects. These instruments generally conform to the voluntary International Capital Market Association (ICMA) Green Bond Principles (GBP). All instruments labelled green that conform to these Principles identify a specific environmental use of the proceeds raised along with describing how projects will be selected, how proceeds will be managed, and how the Issuer will report on the ultimate allocation to certain projects and their corresponding impact.

Issuers may choose to issue in green hybrid format to keep credit ratios at more manageable levels whilst raising capital to fund green CapEx at a lower cost than equity. Credit rating agencies (CRAs) determine the equity content of hybrid instruments based on the intended use of the hybrid program and the features of the notes themselves (such as the ability to convert the principal into common equity or defer coupon payments). This equity treatment subsequently enables leverage metrics, such as Debt to EBITDA, to look more attractive in the eyes of CRAs. These hybrids are structured such that they lose this equity treatment as the coupon steps up and becomes floating on the first call date. CRAs generally expect to see a replacement offering to maintain the size of the issuer's hybrid stack, enabling the instrument to function as a long-term and static capital component.

In the European market, where green hybrids became more popular towards the end of the 2010s and issuers tend to call the bonds at the earliest opportunity to avoid losing equity treatment, we see a significant stock of such instruments now coming due for refinancing. Given that issuers see these instruments as a static component of their capital stacks, many will use the proceeds from new green hybrids to buy back existing green hybrids at

the first call date, and then **re-allocate the same set of original green projects to the new green hybrid offering**. The Green Bond Principles allow for this reallocation of eligible projects so long as they are not earmarked and linked to other green bonds that are still outstanding. **Still, we believe this practice deserves further scrutiny from responsible investors on a case-by-case basis, based on the considerations outlined below.**

Key Considerations for Responsible Investors

- 1** This reallocation practice raises potential concerns over the **additionality** of certain hybrid instruments (whether the security in question can credibly be said to contribute to improved outcomes associated with an issuer's business activities). It may also lead to **double counting** the impacts of the project in question between holders of the various securities.
- 2** By the time projects are reallocated to the new green hybrid, they will generally have been operational for over five years, **materially longer** than what is generally considered an acceptable **lookback period**.²
- 3** The **mismatch in tenor** between the first call date of green hybrids and the lifetime of green projects (which often reach 25 years) raises a question of how many subsequent re-offerings of green hybrids could **retain credit for the outcomes associated** with the initial projects – for example, the annual greenhouse gas (GHG) emissions avoided associated with the generation of a renewable power project.

Overall, these considerations may weaken the case for the green hybrid instrument, from the perspective of investors with corresponding sustainability preference, as there are other green bonds in the market that provide direct exposure to more recently financed or forward-looking projects. However, for CapEx-heavy industries like utilities, the green CapEx opportunity set (volume of capital which could be allocated to environmentally beneficial projects) usually exceeds the size of the issuer's bond programs. As a result, **the main limitation today on labelled green bond issuance these companies would face is often their own leverage limits as opposed to a shortage of eligible green projects.**

¹ Subordinated bonds are a form of debt which ranks after other corporate debts instruments for repayment, if a company falls into liquidation or bankruptcy.

² "Lookback period" refers to the maximum backward-looking timeframe within which a green bond issuer is allowed to select projects that are deemed eligible to receive allocations from a specific green bond's proceeds raised. The traditional maximum allowable lookback period is 24-36 months.

Best Practices for the Allocation of Use of Proceeds

We believe investors who seek to finance progress on the energy transition must develop criteria against which green hybrids can be evaluated to ensure these programs are sufficiently robust. In our analysis of European utilities, we observe that over four cycles of primary hybrid call dates (around 24 years), most renewable energy projects—which represent the majority of the eligible projects associated with utilities’ green bonds—would likely remain active and provide positive GHG impacts in the form of GHG reduction or GHG avoidance (using an assumed lifespan of 25 years for solar and wind projects). Thus, we can say that **green hybrid programs that predominantly finance projects such as renewable power (or those with similar lifespans) may be deemed credible even if some amount of proceeds are allocated to existing projects**, subject to the following considerations:

NATURE OF PROJECTS BEING ALLOCATED TO NEW HYBRIDS

The issuer should include explicit contingencies in their green financing framework³ to address additionality concerns and assure investors of their allocations to new projects. As an example, Engie, a French utility company, in its Green Financing Framework, reserves the right to refinance older projects, but commits to earmark at least 50% of proceeds from new green offerings to new investments in Eligible Green Projects.⁴

Allocating proceeds explicitly to new projects would be a meaningful addition to the opportunity set for investors. If proceeds from hybrids are allocated to existing projects, then they should be reallocated to projects that are within their useful lifespans and are anticipated to produce material impact through first call date of new notes. Issuers could also address additionality concerns with guarantees of frequency of new project injection into the program or the eventual selection of new projects after a certain number of call dates.

TIMING OF HYBRID CALLS

The timing for calling older green hybrids is not always consistent, and there can be some overlap between the offering of new green hybrids and the call date of the older security. We note that CRAs appear to allow for issuance of new hybrid notes up to 18 months ahead of an upcoming call of an existing note, with a typical range of around 6-12 months of overlap. Issuers may even wait until the coupon reset date (1 month after the call date of the previous note).

If existing projects will be earmarked for new hybrids, issuers should clearly communicate the intended overlap window, and ensure de minimis levels of overlap (with a maximum in the range of 6-12 months) for the old and new hybrids both associated with the same projects.

BALANCE OF GREEN PROJECTS TO OUTSTANDING GREEN ISSUANCE

At the issuer level, this balance should be positive such that the issuer has sufficient eligible projects to cover future green bond issuances. Some utilities already adopt a “portfolio,” or “eligible pool” approach for their green financing programs. While this approach is sensible from the perspective of frequent green bond issuers with growing pools of eligible projects, for investors evaluating the outcomes associated with these programs it is important for issuers to provide as much transparency as possible on the project- or asset-level composition of such pools. Investors should advocate for clear information about new project additions and removals, enabling more accurate assessments of their investments.

Conclusion

We believe green hybrid programs that take steps to address the above-mentioned investor considerations (whilst still providing capital structure benefits) can be an important tool for financing the energy transition. By openly discussing these considerations up front with issuers as part of our engagement, we hope to ensure market participants operate with a shared understanding of how these instruments are to be used, with both issuers and investors cognizant of the others’ viewpoint.

³ A green financing framework is the document published by the green bond issuer, outlining the criteria for selecting eligible green projects, and the governance process to monitor and report on them.

⁴ ENGIE, “Green Financing Framework,” June 13, 2023.

Important Additional Information and Disclosures

Source of data: Calvert Research & Management

Date of data: 6/30/2024

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