What is the future of high-yield green bonds?

There has been only a handful of high-yield green bonds to date, but this segment of the market has potential to grow. Impact reporting and the relaxation of restrictions on issuers are two ways in which high-yield paper may differ from investment grade issues, argue **Aaron Franklin** and **Francesco Lione**.

NRG's Borrego generating station

Green bonds are growing - at least among certain types of issuers. Investment-grade issuers, public and private, dominate the field, and high-yield issuers are just beginning to test the waters.

In 2014, 73 different issuers issued $36.6 billion in green bonds, more than triple the amount issued in 2013. Corporate issuers accounted for approximately $12 billion in 2014, with lion's share of the remainder coming from highly rated public entities or multilateral development institutions such as the World Bank.

The vast majority of green bonds so far have been investment-grade. Two high-yield green bonds were issued in 2014: Abengoa Greenfield (rated B by Standard & Poor's) and NRG Yield (rated Bb1 by Moody's).

January 2015 saw one high-yield green bond, from TerraForm Power (rated B1 by Moody's). Altogether, these three high-yield green bonds were less than $2 billion equivalent in aggregate principal amount.

The prospects for high-yield issues

The coming years should see growth in high-yield green bonds, both absolutely and relative to the wider green bond market.

Aaron Franklin

Investors report enhanced awareness of environmental, social and governance (ESG) topics among their stakeholders and seem to ask for increasingly robust assurances that an issuer does not cause or face outsized environmental risk. Furthermore, corporate issuers are increasingly likely to forthrightly address ESG themes in their branding and investor relations. Green bonds could augment that message.

More generally, the breadth of businesses issuing high-yield bonds suggests that many current issuers might fit typical investor definitions of green without adopting the label.

Growth in high-yield green bonds faces headwinds, however. Anecdotal evidence suggests that specialist ESG investors focusing on green bonds are more likely to seek investment-grade credits. Therefore, putting a green label on an issuance is not likely to unlock new capital.

Also, most close observers of green bonds report that, thus far, investors are not generally willing to pay a premium for green bonds, especially in the high-yield space.

What form of green bond would high-yield take?

Participants in the green bond market began asking for tools and standards almost as soon as green bonds took shape. To help develop those tools, in January 2014 a consortium of investment banks established the Green Bond Principles (GBPs), a set of voluntary process guidelines that identify four categories of green bonds and guide issuers, investors and intermediaries on best practices for this emerging phenomenon.

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In April 2014, the consortium added a governance framework that established a secretariat (the International Capital Markets Association), an executive committee and roles for 'members' and 'observers' to the GBPs.

The executive committee consists of six investors, six issuers and six underwriters. As of February 4, 2015, there were 77 members and 35 observers (including Latham & Watkins). These institutions worked over the past year to improve the GBPs. An updated version is expected at the end of the first quarter of 2015.

The GBPs set out four categories of issues:

- "Green use of proceeds bond": proceeds used for "eligible green projects";
- "Green use of proceeds revenue bond": recourse only to the cash flows from the green projects;
- "Green project bond": recourse only to assets of specified green projects; and
- "Green securitised bond": collateralised debt obligation tied to specified green contracts.

The green use of proceeds category is the only one that has been adopted in the high-yield space so far, since generally high-yield bonds provide recourse to all of the assets of the issuer and guarantors, rather than recourse only to certain projects or contracts.

And the existing high-yield green bonds already incorporate the green use of proceeds concept of "eligible green projects", despite the continuing debate around the meaning of green. Each of Abengoa Greenfield, NRG Yield and TerraForm Power promised to use the proceeds of their issuances for eligible green projects in general, with the use of proceeds for the NRG Yield and TerraForm Power green bonds tied to the acquisition of wind power companies.

How might high-yield green bonds differ from investment-grade green bonds?

As this market develops, it is possible that investors will negotiate additional ways to monitor compliance with, and enforce the promise of, proceeds being utilised to fund identified green projects.

Investors may, in exchange for greater responsiveness on the issuers' part, reward issuers with additional flexibility to invest in such projects under the applicable indenture covenants. Two examples follow.

Green impact reporting – High-yield bond covenant packages typically include a robust reporting obligation, which often includes annual and quarterly reporting as well as pro forma financial information for material acquisitions.

By augmenting the existing high-yield reporting covenant, issuers might in the future be required to commit to provide specific updated information regarding the green projects for which they have raised capital.

Current practice, however, is less robust. For example, Abengoa Greenfield promised to report "in a dedicated section of our corporate social responsibility annual report", and NRG Yield promised only to "provide periodic updates" on its website.

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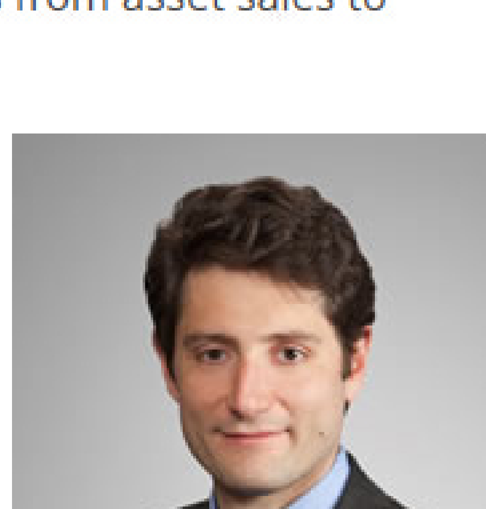
Additional flexibility for eligible green projects – As issuers turn to green bonds, the market might evolve in such a way that investors are willing to relax certain restrictions according to whether doing so would incentivise green activities.

For instance, the restricted payments and the debt covenants might include special additional capacity that would allow issuers to raise debt for or invest in further eligible green projects. This concept could also be applied to the asset sale covenant, which requires that issuers use the net proceeds from asset sales to reinvest in the business within a certain amount of time.

That length of time could depend on whether the net proceeds will be invested in eligible green projects.



Francesco Lione

Interestingly, the green bonds of both NRG Yield and TerraForm Power successfully incorporated a variation on this theme – additional flexibility for green acquisitions. Many bond-financed acquisitions require the issuer to redeem the bonds immediately in the event the acquisition falls through or fails to complete by a certain date. Not so for the NRG Yield and TerraForm Power green bonds. Instead, investors seemed to accept the issuers' promise that, in the event that the respective acquisitions failed, the issuers would invest the bond proceeds in surrogate eligible green projects.

Conclusion: the next step for corporate green bonds

We expect green bonds to grow and investor demand for green investing tools to intensify over time. The next few years should see an increasing market presence for high-yield issuers, but growth in this area will not happen overnight.

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As green bonds move down the yield curve, investors will have access to a more robust spectrum of credits. By enhancing the value of the high-yield bond covenants to issuers, investors might be able to equip themselves with a more robust set of green investing tools.

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