GENERALI ASSET MANAGEMENT

FOCAL POINT

EM ESG issuance still on a back foot

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Our Focal Point series explores topical issues on macro, markets and investment

- **The EM sovereign primary market has continued to recover, with 2024 on track to be the third largest gross issuance year. Market access has improved as EM HY countries' share has increased.**
- **However, ESG issuance of EM sovereigns has continued to decline in relative terms, representing only 13.5% of total sovereign issuance.**
- **Over the next few years, we would expect new EM sovereign issuers to enter the primary market, especially HY countries, but for opportunistic reasons. There will be some diversification in the issuer base, but the market will remain dominated by a f a EUR investor driven market, while in the US ESG policy pushback will limit appetite.**
- **The structure of labelled issuance has also changed significantly. We expect the market to split further between niche bonds (social, sustainability linked bonds) and more established green and sustainable bonds.**
- **The greenium remains difficult to measure given the variety of sovereign issuers, their diversity, and the small sample size. The greenium is heterogeneous across countries with no real clear trend.**

EMs were among the first to be active in ESG sovereign issuance, for example with the very first Sustainability-Linked Bond (SLB, Chile in 2020). However, the share of ESG issuance has declined over the past two years as primary market access has become more difficult and the previously high level of ESG attention, particularly in Europe, has waned somewhat. First, we will take stock of recent developments in EM sovereign issuance, and particularly ESG trends, in light of the considerable easing in market access over the past year. Second, we will focus on the characteristics of ESG bonds issued by EM sovereigns. Finally, we will assess the current level of the greenium.

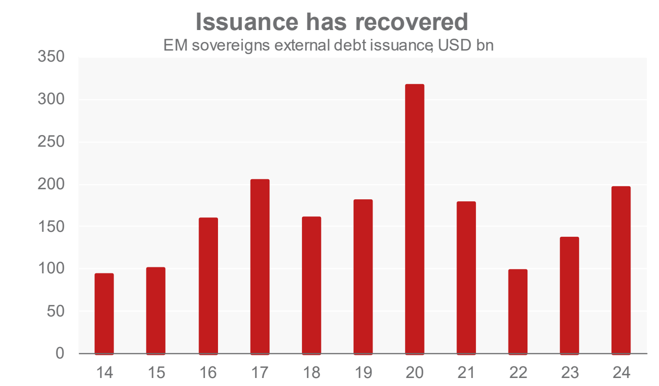
ESG issuance fails to recover despite better market conditions.

Primary markets have continued to recover since the dismal 2022 year, confirming the easing of funding pressures for EM sovereigns. Indeed, EM sovereign issuance has been abundant in 2024, with better market conditions and tighter EM spreads across all buckets. After a slowdown in October, and with the US election behind us, 2024 is still on track to be the third largest year ever in terms of gross issuance, with around USD 196bn of issuance to date.

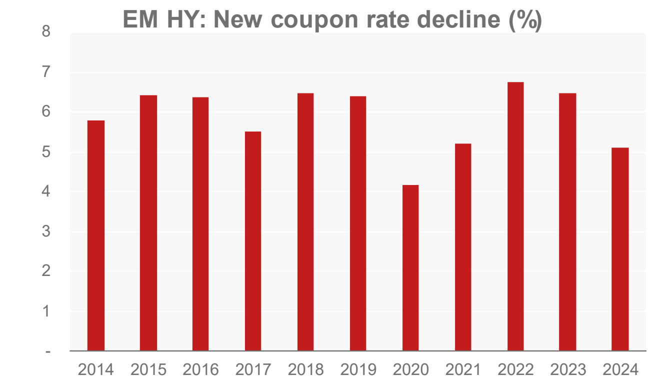
Other positive signs are emerging, suggesting that primary market access has improved significantly.

- First, the share of HY countries in total issuance has rebounded sharply to nearly 33%, almost back to its pre-covid average level. This is a significant change, as the share of HY has been declining steadily since the Covid period. This is accompanied by a strong performance of the B and CCC buckets and the absence of defaults this year. The renewed investor appetite for HY and frontier names has supported the move.

- Second, the average coupon of new issuances has also declined, especially for HY, with levels now well below the pre-covid norm.
- Finally, new issuance has been well absorbed, with the average post-issuance performance of bonds issued this year being positive.



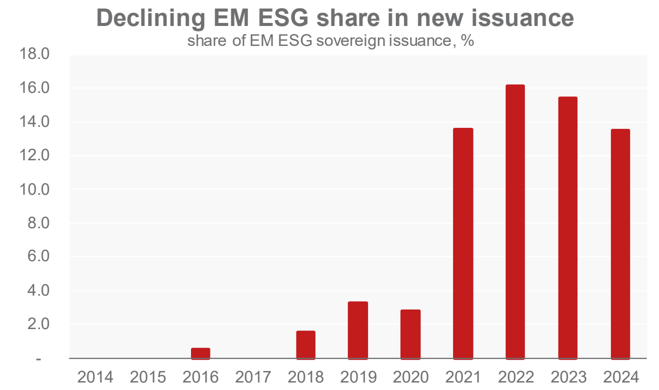
Source: Bloomberg, GenAM



Source: Bloomberg, GenAM

In this positive environment, EM ESG sovereign issuance has continued to decline and now stands at 13.5% compared to 16.1% two years ago. The absolute level of issuance is still growing, but at a slower pace than conventional bonds. This decline can also be observed in the DM space.

In the EM universe, the decline is mainly driven by USD bonds, which have fallen by 20%, while EUR bond issuance has recovered and is close to its all-time high. This is not entirely surprising, as the political backlash against ESG has grown in the US and there has been a setback in the adoption of ESG frameworks. In Europe, ESG is still a dominant factor in investor allocation and EUR issuance now represents 37% of the total new ESG issuance. This is a level in line with what we saw in 2018-2020. Compared to the conventional market, EUR bonds represent only 19%, confirming that the ESG market is strongly driven by EUR investors.



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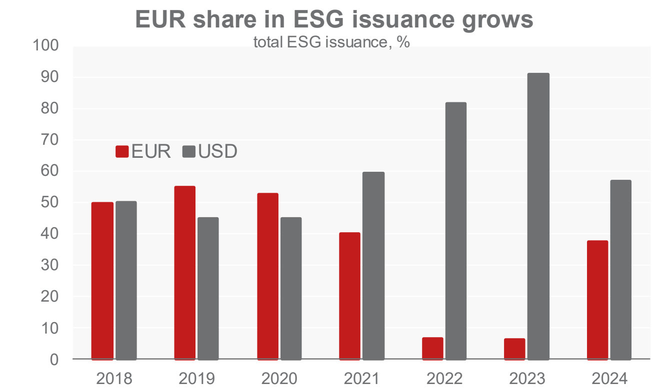
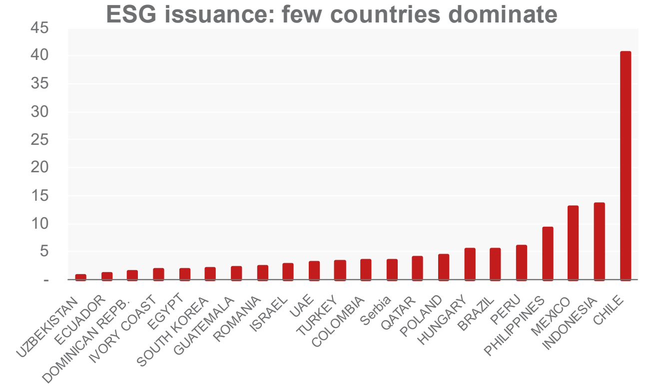


Source: Bloomberg, GenAM

There is also a conjectural factor. ESG remains a small market dominated by large EM IG sovereigns, and it only takes a few countries returning to the primary market to significantly increase the total amount of issuance. For example, the three largest issuers account for more than half of the total market. Only Chile and Uruguay have developed a real ESG issuance strategy, while the other issuers are more opportunistic. As funding pressures in the primary market have eased, new first-time ESG issuers have emerged, helping to slightly diversify the issuer base. For example, Côte d'Ivoire, Serbia, Dominican Republic with their first green bonds or Saudi Arabia with its first green framework. 23 EM countries have so far issued ESG bonds.



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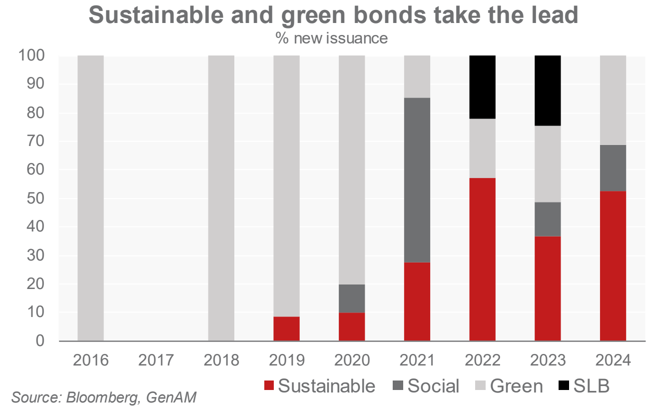


Source: Bloomberg, GenAM

We may see more countries entering the ESG market for the first time, but it should a limited number of countries. Indeed, most of the largest EM sovereigns that wanted to come to the market have done so, and the scope for further expansion is shrinking. New countries which will join the market will likely do it more on an opportunistic basis than a true ESG strategy.

Issuance focusing on green and sustainable bonds

The structure of the ESG market has also changed significantly. We expect the market to split further between niche bonds (social, SLBs) and the more mainstream and established green and sustainable bonds.

The share of sustainable bonds continues to grow and now represents more than 50% of new issuance in 2024, followed by green bonds. These green and sustainable bonds should continue to represent the lion's share of new ESG issuance and become more mainstream as more EM countries continue to issue and improve their frameworks.

Social bonds, which were in vogue after Covid, are attracting less interest with only two issuances last year and in 2023. It remains a niche market and given the reduced attractiveness of ESG issuance, we would expect social bonds to continue to account for a small share. Chile has been the largest issuer so far and we see few signs of new sovereigns entering this market. Rather, we suspect that new ESG issuers will focus on more mainstream green and sustainable bonds, where the framework is well defined and established.

Similarly, SLBs have failed to attract new interest. Chile and Uruguay (2022 and 2023) were the first sovereign issuers to tap this market. These countries are likely to extend their SLBs curve, but given the complexity of the SLB structure, we do not expect multiple sovereigns to experiment with this market. The sovereign commitment is too high, and these bonds are only a good fit for countries with a clear and mature ESG strategy. Investor appetite is also limited by the complexity of the structure and the limited coupon step-up offered in an environment of higher yields than two years ago.

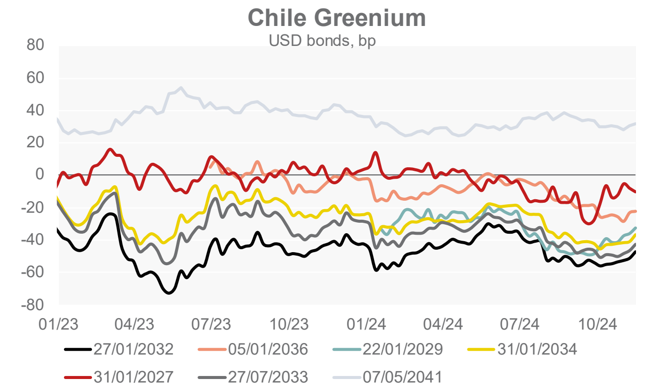
At the other end of the spectrum, more exotic ESG financing solutions are emerging. These typically take the form of blended finance - a mix of private finance backed by multilateral lenders - or debt-for-nature swaps (DFNs). DFNs, which appear to be an attractive ESG solution for frontier economies, have attracted little interest in 2024. Since the well-received Gabon deal in 2023, there have been few smaller deals such as Indonesia in 2024 ($35m). There has been interest with discussion for African DFNs (e.g. Kenya, Angola) or even a multi-country deal to protect the oceans (Kenya, Madagascar, Mauritius, Mozambique, Seychelles, Somalia, South Africa, Tanzania and Comoros). While they represent an achievement in sovereign green finance, they remain an incomplete solution. Their scalability and replicability remain limited, given the small supply pool and low investor demand due to their complexity and the risk of ESG reclassification. DFNs are the solution where there is a nexus between climate/nature and sovereign risks, such as in climate-vulnerable island states. However, the size of DFNs is limited compared to financial ESG needs. We expect to see more deals, but only small ones targeting small countries on an ad hoc basis.

Greenium is still heterogenous

In the early days of the sovereign ESG market, the greenium attracted a lot of interest, which we believe has gradually faded as the sovereign ESG market matures. Still, it remains a useful proxy for appetite and structural demand for ESG assets. It can also be seen as a measure of the ESG aspect of a bond. However, in the EM space, its measurement is difficult and risky, and the strategy implications are not straightforward.

In fact, only a few EM countries (23) issue ESG bonds and their number is only 105. Some of these countries are distressed or HY, where liquidity is scarce and plays a big role in bond prices. It is not like the German twin-bond strategy, where a green bond is issued in parallel with a brown bond, allowing for easy comparison.

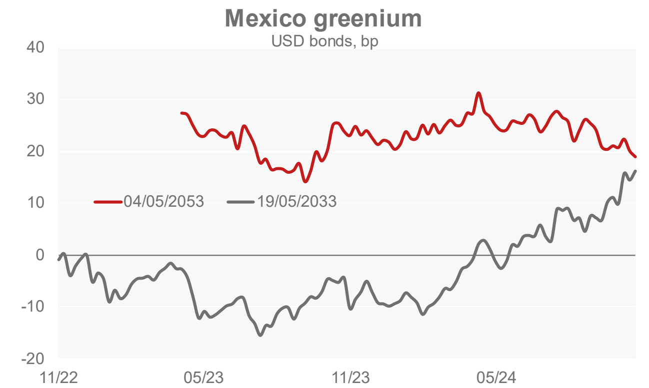
Similarly, the methodology used in the EM space can lead to different conclusions. Here we measure the yield spread between a labelled bond and its synthetic brown equivalent. Unfortunately, some EM sovereign issuers have a small and sparse yield curve, which does not allow for a simple comparison. We have to create an equivalent synthetic brown bond that matches the characteristics of the labelled bond. Again, the yield curve calculation methodology can lead to some basis point differences in the final results, changing the interpretation (positive or negative greenium).



Source: Bloomberg, GenAM

Another pitfall is the significant difference between countries (e.g. Chile vs. Egypt) and it will not make sense to average the greenium of these two countries, which are very different, e.g. in terms of rating. It is more accurate to do this at the IG rating level, and even in the IG space, countries can have very different ESG metrics that can influence the behaviour of ESG investors and so the greenium. For instance, the Philippines being on the GAFI grey list can be excluded for ESG reasons.

Based on our analysis, the greenium has remained heterogeneous across the EM space and has varied widely depending on the country, maturity, rating and even currency. For example, Chile is the best example of the most active and innovative issuer and shows large swings in greenium depending on the maturity of the bond. For Mexico, which is one of the largest issuers of external debt with a liquid curve, the USD 2033 has seen its greenium rise and turn positive, while the USD 2053 has seen its greenium fall slightly.



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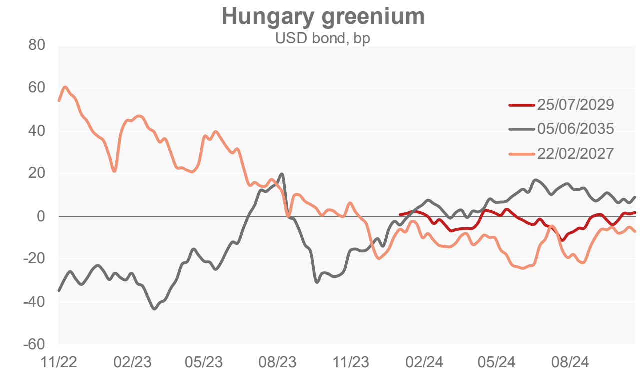

Source: Bloomberg, GenAM

Conclusion

EM sovereign ESG issuance, while increasing, has not kept pace with the recovery in primary market activity. Over the next few years, we would expect new EM sovereign issuers to enter the primary market, especially HY countries, but just for opportunistic reasons. There will be some diversification in the issuer base, but the market will remain dominated by a few names. We expect a limited number of countries to develop a full curve, such as Chile, or enter the SLB market. EM ESG issuance will remain a EUR investor driven market, while in the US ESG policy pushback will limit appetite. As for the greenium, it should decline on average as the market matures. However, it is very heterogeneous and varies across countries and maturities, as demand from ESG investors is only one component of demand among many others.

Imprint

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