Information for investment professionals

Uruguay's experiment in sovereign sustainability-linked bonds

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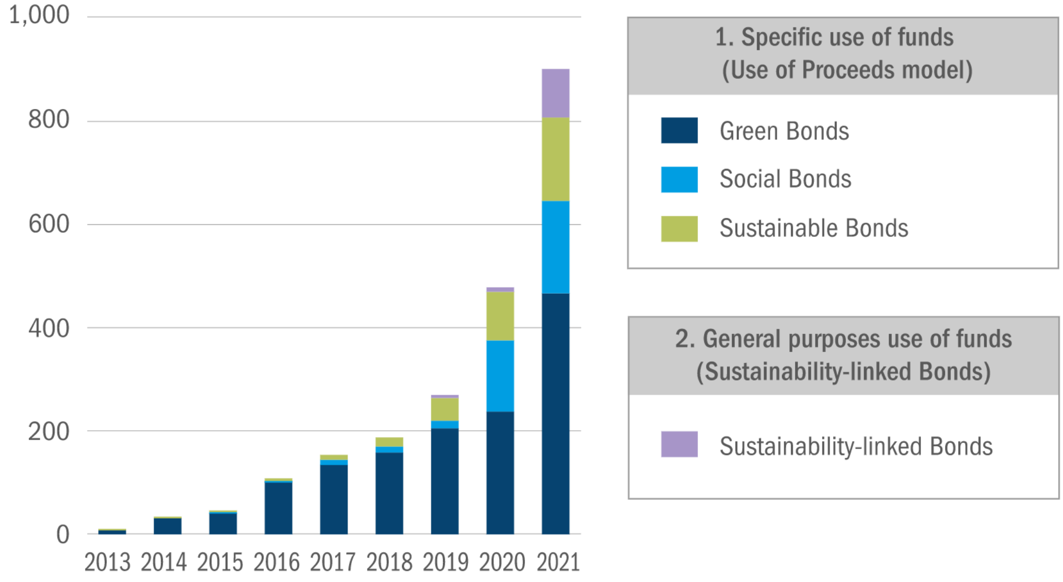
- **Sovereign sustainability-linked bonds are a debt instrument that hold a government accountable for environmental policy, potentially closing the credibility gap of emerging market ESG initiatives**
- **Uruguay's issuance will be tied to its ability to make progress towards goals outlined in the Paris Agreement**
- **If successful EM sovereigns could establish a new source of financing, attracting a larger investor base while enhancing their sustainability goals**

Uruguay has made strides in ESG (environmental, social and governance) investing with the issuance of a sustainability-linked bond (SLB), making it only the second sovereign issuer to do so. A SLB is a new type of debt whereby the market holds the issuer – in this case the Uruguayan government – accountable for its environmental policy actions. The bond's coupon will be tied to Uruguay's ability to make progress towards goals outlined in the Paris Agreement. The issuance makes headway in solving a credibility issue which exists with current ESG debt, where issuers often aren't held to any specific standards for policy change. We are excited about an innovation that should offer transparency and impact – the ultimate goal for ESG investors. If it works, we expect to see this model copied by other sovereigns in the future.

Tapping into a rapidly growing market

ESG investing is a rapidly growing segment of the debt market with room for innovation. ESG-labelled bond issuance made up 5.1% of global bond issuance in 2021, up from 0.3% in 2015, according to the Institute of International Finance (IIF). It sees potential for the volume of ESG debt issuance at 4x current levels by 2025 . So far, issuances are concentrated in green bonds (Figure 1), which promise to put money towards climate and environmental initiatives. Sustainability-linked bonds are general purpose bonds – ie they don't finance a particular project – but the issuer commits to pre-set targets related to environmental sustainability.

Figure 1: total global volume of thematic bond issuance (USD billions)



Source: Ministry of Economy and Finance of Uruguay, Sovereign Debt Management Unit/Credit Agricole, October 2022.

Mechanics of the SLB

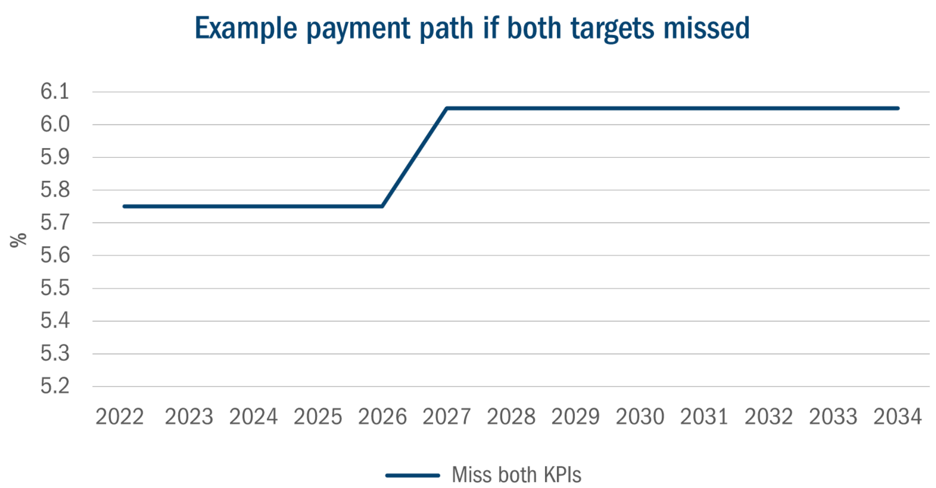
The Uruguayan government has two pre-set targets, to be measured as of 31 December 2025 relative to a base year:

1) 50% reduction in greenhouse gas emissions per unit of real GDP from base year 1990; and

2) 100% maintenance of forest area from base year 2012.

The bond has a penalty/reward structure for performance, with a step-up in the coupon if targets are missed and a step-down if they are exceeded (Figure 2).

Figure 2: example payment path if both targets are missed



Source: Columbia Threadneedle analysis, October 2022

Tying payments to environmental outcomes adds a layer of accountability for the government, creating a much more transparent ESG debt instrument. For investors, assessing the risk-adjusted return profile for Uruguay becomes easier thanks to more frequent data publications. The SLB saw strong investor demand on the primary market at 4x oversubscribed and priced at favorable terms, despite the possibility of a coupon step-down.

Putting in the effort

Uruguay is able to achieve this issuance as an investment grade, credible issuer that already ranks highly on various ESG indicators (Figure 3). Chile, another EM high-grade country, is the next best example, and issued the sovereign market's first SLB in March of this year . As investors we will be assessing an issuer's effort in meeting these targets as part of our ongoing due diligence. Uruguay's targets are ambitious. The pace of emission intensity reduction, for example, will need to be above historical performance – a challenge given much of the infrastructure transition towards a lower carbon economy was done in the past decade. Most of Uruguay's carbon emissions come from cattle raising, a key export.

Figure 3: EM credit and ESG ratings

Composite credit rating

ESG rating, CTI	B	BB	BBB	A	AA
1	Costa Rica		Uruguay Panama Malaysia Romania	Chile Poland	UAE
2	Mongolia Jamaica	Colombia Paraguay	Peru Mexico		

Source: Columbia Threadneedle Investments (CTI) analysis of data from Standard & Poor's, Moody's and Fitch, October 2022

How do SLBs benefit investors?

The market will be monitoring Uruguay's progress and pricing in the probability of it hitting the targets. Even though the coupon change won't be assessed until early 2027, the sovereign spread will fluctuate as data and news is released throughout the tenure of the bond. Having a third-party enter the contract to verify both the validity of the targets and results at each measurement period keeps the government honest in their progress, and helps investors assess country risk. There should be a scarcity value to this bond and it trade with less volatility given the objectives of its investor base.

Uruguay is setting off on what will be an iterative process for future sovereign debt issuances. As ESG becomes an increasingly important factor in portfolios, we expect other countries to follow their lead with similar instruments. Investors want greater differentiation in their portfolios, measurable impact and the ability to engage with governments – all elements that a bond like this potentially accomplishes. Uruguay's issuance is a step in the right direction for EM debt, and we are excited to see how it plays out.