VAN LANSCHOT KEMPEN

INVESTMENT MANAGEMENT

Market Musings 6/24

For Professional Investors only

The Euro's Hidden Success

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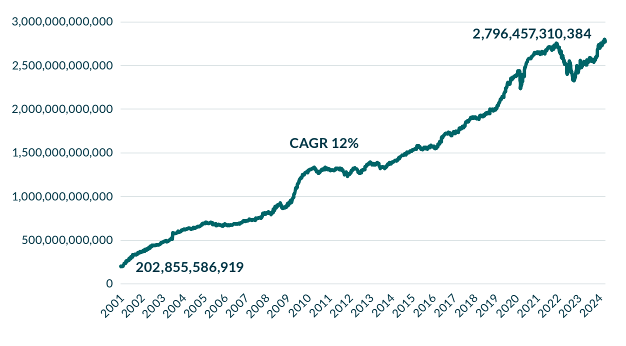
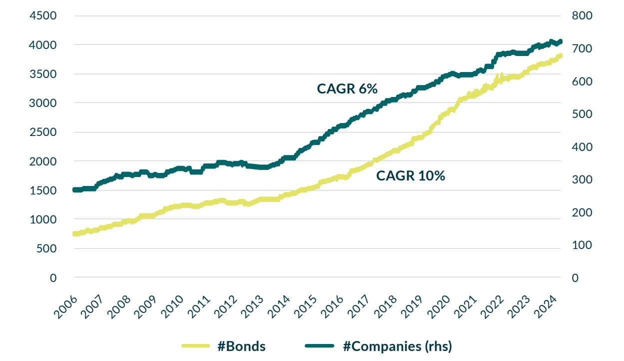
Since the inception of the European common currency the euro bond market has grown spectacularly. While there are prominent political demands for the establishment of a more integrated and expansive capital markets union, we consider the expansion of the bond market realised so far as one of the lesser known triumphs of the euro.

However, with the pool of bonds growing strongly, this highlights the need for investors for an active approach. Having a thorough understanding of the market can allow active investors like us to add value, including in the sustainable bonds market.

Market Value



Increased Volume of Bonds and Issuers



Source: IHS Markit — iBoxx Euro Corporates index

Burgeoning bond growth...

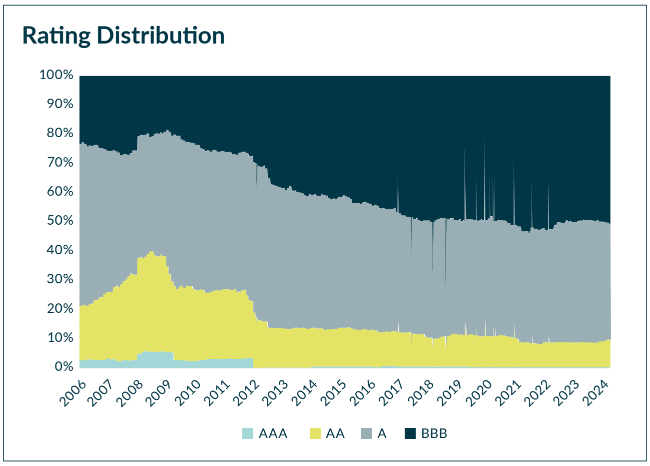
In the last two decades, the market for investment grade debt funding in euro has witnessed a stellar 14-fold increase. Commencing at the start of the new century, the investment grade credit markets have consistently expanded at a yearly rate of c12%, reaching a market value of EUR 2796 billion by January 2024. This growth rate has outpaced that of the US debt market, which has seen an annual growth rate of 9%.

Furthermore, there has been a notable surge in the number of companies accessing the euro debt markets, with the current count of company bond issuers reaching 722 today, compared to 267 in 2006 and c150 in 2001. This is mirrored in the number of bonds issued, as existing issuers increased the amount of bonds brought to the market.

We see several factors that have contributed to this remarkable growth. In comparison to bank loans, the euro debt market provides greater efficiency in terms of time, volumes and spreads. Companies, therefore, are able to secure funding more quickly, with tighter spreads and fixed terms. The catalyst for exploring this market arose when companies faced more challenges obtaining bank loans during and after the financial crisis of 2007-2009. This forced them to seek financing from the bonds markets instead. Additionally, we have also seen the euro bond markets maturing over time, attracting additional money from investors looking for diversification away from domestic or US debt markets.

... with deteriorating quality

However, quantity does not equal quality. Another striking observation is the steady decrease of AAA rated bonds as percentage of the market, with BBB ratings taking more space, particularly since 2013 as shown in the graph below:



Source: IHS Markit — iBoxx Euro Corporates index

This again can be attributed to the financial crunch prompting more companies to enter the bonds markets and the weakening of credit ratings during the crises. Another explanation is the introduction of more enhanced information systems, enabling analysts to rate a broader range of companies which has increased the willingness to invest in BBB rated companies.

This situation does not have to be perceived as negative per se. It signifies a trend of companies seeking funding through capital markets, indicating a more accessible market for companies with lower ratings. Efforts to expand the market even further are underway, as seen by the recent advocacy from French president Macron and German Chancellor Scholz for a more active approach toward achieving a fully integrated single market for capital across the European Union. This would encourage economic growth and innovation, by making more capital accessible to a wider range of companies.

However, this also implies that the overall market now has a lower average rating compared to a decade or two ago. Investors should keep this in mind when tracking and investing in this market: passively following the index (ETF's) could now result in more nasty surprises than in the past.

More choice for cherry pickers

With a more diverse set of companies issuing bonds on the market, for active investors this opens up more possibilities for cherry picking. As an example, after interest rates rose strongly in 2022 bonds of real estate companies saw strong price declines as many of these companies were not so well known by investors and were operating with stretched balance sheet metrics. As fear spread, real estate companies with solid credit metrics sold off as well. For investors who did their homework, this presented an opportunity to buy these bonds at very attractive levels.

Green or social: know your companies

As a specialist investment manager we aim to guide clients through the transitions towards a more sustainable economy. Naturally we therefore see the strong growth in the number of Green, Social and Sustainability linked bonds as a positive development. Since the first green bonds were issued by the European Investment Bank in 2007, this sustainable universe has grown explosively, with currently close to 19% of the euro corporate universe consisting of green, social or sustainability linked bonds, again reflecting the expanding opportunities in this sustainable investment space.

The Kempen Euro Sustainable Credit Fund has a higher number of Green, Social and/or Sustainability Linked Bonds in the portfolio compared to benchmark (23.4% vs 19.0% as at 31 May 2024*). In this universe, active management, knowing your companies, can prove very advantageous. Not only to avoid companies that use this expanding universe for greenwashing but also to realise alpha, as shown overleaf.

> By carefully selecting opportunities from both the traditional and sustainable bond markets, active managers like us can add value for our clients.

*Source: IHS Markit iBoxx global green, social & sustainable bonds index

The devil is in the detail: a case study of success

Smart positioning in a European utility company has recently given us a performance edge. The company is considered to be a leader in carbon emission reduction, being one of the first to issue Sustainability-linked bonds (SLB). These bonds include provisions where the coupon increases if the issuer fails to meet specific sustainability goals, known as Key Performance Indicators (KPIs), by a certain deadline. This information is provided in the bond prospectus: however, the market does not always take notice.

The company has multiple SLB bonds outstanding, each with its own KPI and deadline. One is a 2030 bond with a KPI requiring the reduction of CO2 intensity from power plants to below 148 g/kWh by the end of 2023.

While this business made significant progress in reducing CO2 intensity that year (from 229 to 160 g/kWH), the target proved slightly too ambitious due to valid external factors. As a result, certain of their SLB bonds now pay a 0.25% higher coupon for the remaining duration.

We started to anticipate this potential outcome when the CEO mentioned the challenge of meeting the CO2 intensity target during the presentation of the half-year figures. We also noticed that the spreads of the SLB bonds with the CO2 2023 deadline included were not significantly different from regular bonds. This indicated an opportunity for value creation. We then took an overweight position in the affected bond, leading to a significant price increase for this bond by the end of March.

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