

Here we go Orlen: SLBs step back down

Josephine Richardson (*)

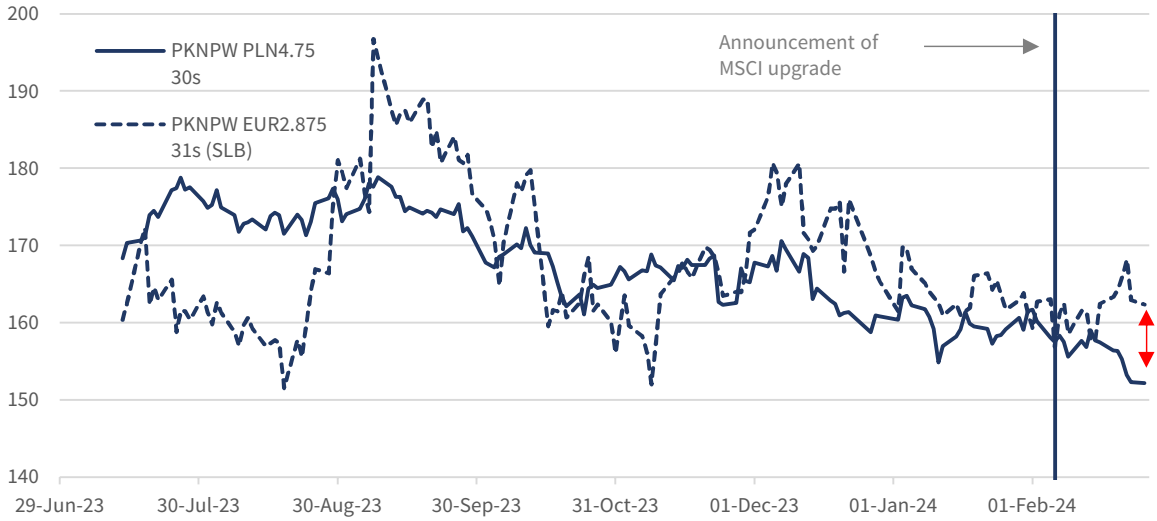
PKN Orlen (ticker PKNPW), a Polish oil refiner and petrol retailer, has issued two Sustainability-Linked Bonds (SLBs) with coupons linked to the issuer's MSCI ESG rating. In December 2021 the issuer was downgraded from A to BBB which triggered a step-up to the coupon on both bonds.[1]

On 6 February 2024 Orlen reported that its rating was upgraded back to A which will trigger a step-down on its SLBs coupons.[2] **Orlen was the first SLB to miss a target and pay a step-up. This will be the first time a KPI has subsequently improved triggering the coupon to step-down again.** This highlights the importance for SLB investors of monitoring KPIs that directly impact their bonds.

We would expect the coupon step-down to lead to an underperformance of the bond spreads. Comparing recent price moves to the closest maturity EUR bond suggests some relative widening of the PLN 7y SLB since the announcement (see Figure 1). The spread between these bonds is historically volatile, likely as the different currencies mean they have very different investor bases. The step-down is only 10bps, which makes a definitive market reaction harder to identify.

Continuous observation of KPIs can make structures more complicated to price, however this situation demonstrates the ongoing positive incentives they provide for issuers,[3] since they ensure alignment between issuers and investors towards sustainability improvements.

Figure 1. Orlen historic bond bid z-spreads. Source: Bloomberg, accessed 27 Feb 2024.



[1] For our earlier analysis please see "One small step for Orlen, one giant leap for the SLB market", AFII, 29 Nov 2022.

[2] "Orlen's ESG rating upgraded", Orlen, 6 Feb 2024.

[3] A similar incentive can be provided by issuing a series of SLBs with successive observation dates and triggers, for example PPC's potential turnaround having missed one SLB target as detailed in "PPC: Coal decommissioning success impacts SLBs", AFII, 19 Feb 2024.

Not investment advice. This version 28 Feb 2024. Important disclaimers at end of the document.
(*) Anthropocene Fixed Income Institute (www.anthropocenefii.org). Author for contacts: jor@anthropocenefii.org

Bonds outstanding

Table 1 gives details of Orlen's outstanding bonds; two SLBs, one green bond and the most recently issued bond which is not ESG-labelled.

Table 1. Orlen bonds outstanding. Source: Bloomberg, accessed 27 Feb 2024.

Description	ISIN	Issue Date	Maturity	Bond Type	SLB Coupon Step	Currency	Amount Outstanding
PKNPW €1.125 28s	XS2346125573	27-May-21	27-May-28	Green		EUR	0.5
PKNPW €4.75 30s	XS2647371843	13-Jul-23	13-Jul-30	Vanilla		EUR	0.5
PKNPW PLNFloat 25s	PLPKN0000208	22-Dec-20	22-Dec-25	SLB	0.05%	PLN	1.0
PKNPW PLN2.875 31s	PLO037100016	25-Mar-21	25-Mar-31	SLB	0.10%	PLN	1.0

SLB details

The two SLBs (full details in Table 1) are a 2025 bond issued in December 2020 and a 2031 bond issued March 2021. Both SLBs use a KPI referencing the MSCI ESG rating of the issuer, which was A at issuance. It is more usual for a KPI to have a single Sustainability Performance Target (SPT) at a single observation date. These bonds, having a KPI linked to an ESG rating,[4] are effectively continuously observed and can step-up and back down in theory at each coupon date.

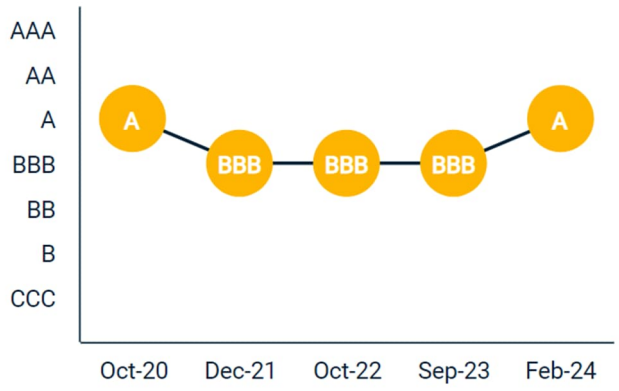
When probabilities of coupon steps change, we would expect the bond spread to react; tightening when a step-up is more likely or a step-down is less likely and widening when a step-up is less likely or a step-down is more likely. This would be offset by any impact on creditworthiness due to the change in sustainability KPI, here ESG rating.

When the downgrade caused the coupon to step-up, our analysis at the time showed no material market reaction, suggesting that these two effects were either balanced, or both insignificant.

Rating history

Figure 2 shows the historic values for Orlen's MSCI ESG rating. Orlen was rated A when the two SLBs were issued, was downgraded in Dec 2021 and has just been upgraded again.

Figure 2. MSCI ESG rating for PKN Orlen. Source: MSCI, accessed 27 Feb 2024.



Orlen has reported that progress on environmental factors has contributed to the recent rating upgrade: *"Significant progress has been noted in emissions reporting, decarbonisation plans, and leveraging investment opportunities in energy transition supported by clean technologies."*[2]

[4] We acknowledge limitations in ESG ratings, and accept they are a proxy for sustainability performance.

MSCI determines Orlen's rating to be 'average' among the 165 companies rated in the oil & gas refining, marketing, transportation & storage industry.[5]

The value of a continuously observed KPI is that there are ongoing incentives for an issuer to improve its sustainability performance throughout the length of the bond. While Orlen's rating may still only be 'average', it is positive to have improved emissions reporting and decarbonisation plans. The SLBs may have provided motivation to make these enhancements.

Conclusions

Orlen's SLBs were the first to miss targets and pay step-up coupons. At the time, market reaction was limited, but it was encouraging to see the event flow operationally smoothly.

Due to an unusual structure where the KPI is continuously observed, a recent upgrade to Orlen's ESG rating will cause the coupon to step-down, another first for a nascent market.

This is a good example of how ongoing sustainability targets (either through continuous observation or different bonds with different targets), can motivate issuers continually to improve their sustainability performance.

[5] "Orlen Spolka Akcyjna", MSCI, accessed 27 Feb 2024.

IMPORTANT DISCLAIMER:

This report is for information and educational purposes only. The Anthropocene Fixed Income Institute ('AFII') does not provide tax, legal, investment or accounting advice. This report is not intended to provide, and should not be relied on for, tax, legal, investment or accounting advice. Nothing in this report is intended as investment advice, as an offer or solicitation of an offer to buy or sell, or as a recommendation, endorsement, or sponsorship of any security, company, or fund. AFII is not responsible for any investment decision made by you. You are responsible for your own investment research and investment decisions. This report is not meant as a general guide to investing, nor as a source of any specific investment recommendation. Unless attributed to others, any opinions expressed are our current opinions only.

Certain information presented may have been provided by third parties. AFII believes that such third-party information is reliable, and has checked public records to verify it wherever possible, but does not guarantee its accuracy, timeliness or completeness; and it is subject to change without notice.

Any reference to a company's creditworthiness or likelihood of positive or negative performance in the current or future market is purely observational and should not be taken as a recommendation or endorsement or critique of such company or security.

AFII is a non-profit organisation "to monitor, advocate for and influence the impact of the fixed income and bond markets in the age of human induced climate change". For more information about the Institute, please visit www.anthropocenefii.org.

AFII is not in any way associated with, nor are any of its directors, employees or advisors, any of the companies it references in its materials or reports and is not receiving compensation or consideration of any nature for its observations and/or insights.

