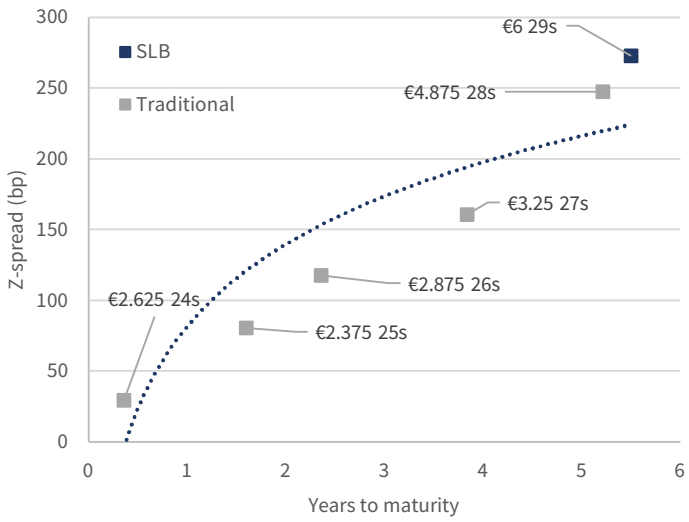
Le SLB d'Auchan, il change la vie?

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Elo Group (ticker ELOFR), a privately-owned French holding company, priced its first Sustainability-Linked Bond (SLB) on 19 Sep. The unrated bond (ISIN FR001400KWR6) totals €0.75bn, and was issued at a spread of mid swaps + 278bps.

Figure 1. Auchan bond spreads, above $250mm issue size. Source: Bloomberg, accessed 21 Sep 2023.



From an environmental point of view, Elo Group's climate footprint is driven by Auchan, a French supermarket chain. The food sector is under increased pressure to improve its environmental footprint, particularly because recent EU deforestation regulation requires all products sold in the EU to be from deforestation-free supply chains.[1] Given that 51% of Elo Group's revenue was generated in France alone in 2022, this is a material piece of regulation for investors in the company's debt.[2]

In this note we analyse the Elo Group's new SLB, and compare it with other recent structures. We evaluate the KPIs and assess the probability of investors receiving the step-up coupon.

- **The SLB product commits an issuer to ongoing sustainability reporting**, and therefore has the scope to increase transparency in a challenging sector. SLB investors have a role to play in scrutinising emissions reductions as an input into their investment decisions.[3]
- Emissions reporting standards in the agriculture sector are going through welcome improvements, with the introduction of SBTi's Forests, Land and Agriculture (FLAG) guidance.[4] **While Elo Group will incorporate this guidance in the future, this creates uncertainty for SLB investors, which may be a driver of its wide pricing.**
- **We estimate the SLB option to be worth 5bps running for SLB investors, i.e. the SLB should price 5bps tighter than vanilla debt.** Current bond spreads (as shown in Figure 1) suggest the SLB is positioned quite wide compared to traditional debt, and so may be underpricing this option value.

[1] For our analysis of see "EU deforestation law: fire on the horizon for soy traders?", AFII, 13 Sep 2023.
[2] "Annual Financial Report Non-Financial Performance Statement 2022", Elo Group, 28 Feb 2023.
[3] For an example of this see "The Forensic Carbon Accountant: JBS SLB", AFII, 21 Sep 2023.
[4] "Forest, Land and Agriculture (FLAG)", SBTi, accessed 21 Sep 2023.

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Background: Auchan Retail dominates Elo Group's emissions footprint

Elo Group is structured as three independent companies: Auchan Retail, a French supermarket chain, New Immo Holding, a real estate developer and Oney, an online financial services provider which is 49% owned by Elo Group.

From a sustainability point of view, Elo Group's footprint is dominated by Auchan Retail, which contributed 92% of its Scope 1 + 2 emissions in 2022.[9]

In March 2022, Auchan published a policy document outlining its commitment to fighting against deforestation,[5] including a series of ambitions and objectives for 2025 such as 100% of food supplies coming from production areas that do not result in deforestation. Setting objectives for 2025 temporally aligns Auchan's approach with the no-deforestation commitment included as a requirement of the FLAG guidance from SBTi.[4] In spite of these stated policies, Auchan is scored poorly by Forest500,[6] with a notably low score for the implementation and reporting section of Forest500's methodology.

Before the SLB, ELOFR had five bonds outstanding, issued between 2019 and 2022. Full details are shown in Table 1.

Table 1. ELOFR outstanding bonds greater than $0.25bn. Source: Bloomberg, accessed 21Sep 2023.

Description	ISIN	Issue Date	Maturity	SLB	Currency	Amount Outstanding
ELOFR €2.625 24s	FR0013399060	30-Jan-19	30-Jan-24		EUR	745,900,000
ELOFR €2.375 25s	FR0013416146	25-Apr-19	25-Apr-25		EUR	695,100,000
ELOFR €2.875 26s	FR0013510179	29-Apr-20	29-Jan-26		EUR	848,900,000
ELOFR €3.25 27s	FR0013524865	23-Jul-20	23-Jul-27		EUR	716,000,000
ELOFR €4.875 28s	FR001400EHH1	08-Dec-22	08-Dec-28		EUR	650,000,000
ELOFR €6 29s	FR001400KWR6	22-Sep-23	22-Mar-29	Y	EUR	750,000,000

The issuance of an SLB has the potential to provide accountability for a privately-owned company, that often has poorer disclosures. Retail, and its impact on land-use change, is a climate-relevant sector, so further transparency around Elo Group's emissions is important in trying to reduce them.

[5] "Lutte contre la déforestation : Auchan s'engage", Auchan Retail, Mar 2022 (French)
[6] "Forest500 – Association Familiale Mulliez (Auchan Holding)" Forest500, accessed 21 Sep 2023.

SLB structure

This SLB was priced on 19 Sep 2023, with a coupon of 6%. The €0.75bn bond was covered 2.07x, which compares poorly with the average book size of 3.67x for Sep 2023.[7]

It has two KPIs, both related to absolute emissions. This represents a shift from its 2021 Sustainability-Linked Loan with two energy-related KPIs.[8]

The 2030 emissions targets are all reported as aligned with SBTi.[9] Scope 1 + 2 are aligned with 1.5°C, whereas Scope 3 is aligned with well-below 2°C.

Table 2. Elo Group SLB details. Source: Elo Group.

Issuer	Elo Group
Ticker	ELOFR
ISIN	FR001400KWR6
Pricing Date	19-Sep-23
Maturity	22-Mar-29
Coupon	6.0%
KPI Observation Date	31-Dec-26
Max Step-up	0.375%

FLAG emissions

One point of interest regarding Scope 3 emissions is new guidance from SBTi regarding Forest, Land, and Agriculture (FLAG) emissions.[4] FLAG addresses an important methodology gap, around how to consider Scope 3 emissions coming from land use.

According to the guidance, from April 2023 onwards companies meeting the FLAG criteria (such as Food and Staples Retailing companies) that are in the process of setting targets, are also required to set FLAG targets. The current reported Scope 3 emissions include only those from purchased goods and services, upstream transportation & distribution, and use of sold products, which does not include FLAG emissions.

However, Elo Group's Scope 3 methodology allows for an updated baseline to be published in H2 2024 / H1 2025 to include FLAG emissions.[10] We notice that some other retailers have already incorporated FLAG emissions, specifically REWE, a German retailer, issued an SLB earlier in the month that did include FLAG emissions.[11]

It is positive to be including all emissions and specifically those from land use which historically have not been reported. However, uncertainly around the baseline makes predicting future emissions even harder.

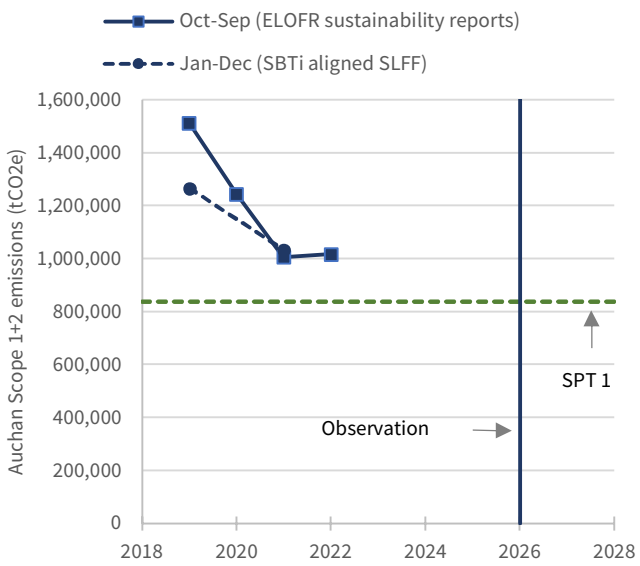
[7] Sourced from Bloomberg, average book size for corporate issuance above €0.5bn.
[8] "ELO aligns the renewal terms of a €800 million syndicated credit line with the success of its actions to combat climate change", Elo, 4 Nov 2021.
[9] Described in the "Sustainability-Linked Financing Framework", Elo Group, Sep 2023.
[10] "Measurement methodology for Scope 3 emissions", Auchan, accessed 21 Sep 2023.
[11] This bond was covered in "Sustainability-Linked Bond Bumper Week", AFII, 11 Sep 2023.

KPI 1

Elo Group's first KPI relates to its Scope 1+2 GHG emissions, with the related SPT targeting a 34% reduction in 2026, from a 2019 baseline. The coupon will step up 12.5bps if this is not achieved.

This target is a linear interpolation of the gap between the 2021 figures, and the SBTi aligned 2030 target. An 18% reduction was achieved from 2019-2021, leaving only a 28% reduction needed in the remaining nine years.

Figure 2. Elo Group historic emissions. Source, Elo Group.



Understanding its historical reporting is made more complicated by the fact that its annual reports give data for October to September, whereas for the SBTi target setting process, data is recalculated from January to December,[12] for which fewer data points are available.

There is also some ambiguity around the Scope 2 calculation. Only since 2021 have both location-based and market-based emissions been reported, but it is not disclosed which is used for the total emissions. The SLFF reports that a strategy to achieve SPT1 includes *"the purchase of green energy through guarantee-of-origin contracts",*[9] which we interpret as meaning market-based Scope 2 emissions and is what we have used in Figure 1 above.

We use Jan-Dec data to interpret drift, with an average of -9% per year, but Oct-Sep to interpret volatility, suggesting a 11.2% annualised rate, as there are more data points.

KPI 2

Elo Group's second KPI covers its Scope 3 emissions, described in the SLFF[9] as those deriving from purchased goods and services, upstream and downstream transportation, and use of sold products. The document notes that the FLAG project will result both in restatements of Scope 3 emissions, but also potential new targets. These will be split into FLAG and non-FLAG indicators, aligned with 1.5°C. This represents an improvement as the current Scope 3 emission targets are only aligned with well-below 2°C.

It is positive to see enhanced reporting incorporated, and that the SLB will be flexible enough to include this, although we note a competitor, REWE, has already managed to calculate FLAG emission levels and targets.[11]

This will also create a high degree of uncertainty with regards to analysing the likelihood of achieving this target. We would note, the improvement from well below 2°C alignment to 1.5°C alignment makes it more ambitious.

[12] This is noted in a footnote to the historical data table in the SLFF on p21.

The coupon will step up 25bps if this target is not achieved, placing higher materiality on the Scope 3 target.

SLB option pricing

AFII has developed an SLB pricing method, where the step-up probabilities are priced using a Black-Scholes framework.[13]

The maximum coupon step-up is 37.5bps paid for two years. This does not meet the minimum threshold to qualify as a "Greenback SLB", where the discounted step-up value, using an illustrative 50% probability, must be greater than 1%.[14]

Historical data for KPI1 has allowed us to estimate its dynamics, which estimate a probability of 14% of missing the target, and so paying the step-up coupon. KPI2 is much harder to consider, driven by the lack of data and the moving target of future incorporation of FLAG emissions. We estimate a 50% probability of missing the target, due to the improved SBTi target alignment.

Using these parameters, we calculate the total value of this option to be 0.25% or 5bps running. This is 1.8% of the issuance spread. Figure 1 shows current pricing of ELOFR bonds. The new SLB is the longest dated, which makes a comparison hard. It seems to be pricing 25bps wider than the 4.875% 28s which is only three months shorter in maturity. This pricing may well still include some new issue premium, but still seems wider than it is were pricing the SLB option value.

Conclusions

While there are doubts about the sustainability impact of some SLBs, the very act of issuing this product represents a positive step in terms of openness and accountability. SLB bondholders have a powerful voice in requesting transparency from issuersbecause SLBs are a financial derivative, in that they derive their value from KPI reporting.

The climate impact of deforestation from agricultural companies is garnering more attention. Current emissions reporting from Elo Group unfortunately does not include most recent SBTi FLAG guidance.[4] While it is promised in the future, this limits the ability of SLB investors to analyse current emissions trends and targets.

Considering all these factors, we estimate the SLB option is worth 5bps running, due to the probability of receiving the step-up coupon. Current bond spreads suggest this is not yet priced in.

[13] This is described in full detail in "An option pricing approach for sustainability-linked bonds", AFII, 8 Nov 2022.
[14] Please see "Greenback SLBs: an impact standardisation proposal", AFII, 10 May 2023.

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