THE DAILY CHECK-IN WITH GOLDMAN SACHS

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Liz Bowyer: Hi, Jonny.

Jonny Fine: Hi, Liz. How are you?

Liz Bowyer: Good, thanks. You help our corporate clients access the debt capital markets and also spend a lot of time on our growing ESG financing business. Just to start, give us a sense of how ESG financing activity has changed in recent years.

Jonny Fine: So, Liz, there's no doubt that the journey that corporate America is on has evolved rapidly in the last couple years. 2019 was really the watershed moment for corporate America. That's when we saw $31 billion of ESG-linked supply in the US market. Multiples of anything we'd seen in any prior year. We also saw, with the growth of companies wanting to finance the S in ESG, came the ability to combine E and S together in the form of sustainability bonds. Securities combine the features of both green and social bonds together. This is one of the fastest-growing segments of the ESG financing market. Year to date we've seen $8 billion in sustainability bonds issued.

But the actual fastest-growing segment of the market is the sustainability-linked market. Sustainability-linked bonds, or SLBs, those are structured to hold issuers to account the ESG-related KPIs they have committed to. Here, the rate of interest the company pays on those bonds may increase if the company fails to meet these stated KPIs. And importantly, unlike green, social, and sustainability bonds, these proceeds are specifically earmarked for investment projects that advance environmental and social causes. The proceeds from SLB issuance are for general corporate purposes, like most other regular-way bond issuances.

Liz Bowyer: And is that just an investment-grade phenomenon?

Jonny Fine: Actually, Liz, and encouragingly, we've seen, not in the rapid adoption of ESG finance across all industries within the investment-grade world, we are now seeing this transition to the sub-investment-grade markets. In the first quarter of this year, there was just under $5 billion of high-yield ESG securities issued across green bonds and SLBs, which now puts year-to-date high-yield ESG issuance in line with full-year 2020. And this is a market where Goldman Sachs has been playing a leadership role.

We structured the first-ever investment-grade-rated SLB in 2019 as well as the first and second high-yield-rated SLBs last quarter.

Liz Bowyer: And what's driving this volume from the perspective of corporate insures?

Jonny Fine: So, Liz, I view ESG financing as an outcome of a corporation's robust sustainability program. By definition, the decision to invest in or build a qualifying green asset or to invest in a qualifying social program isn't driven by the existence of the ESG financing markets. But once these programs are created and committed to, many companies are then able to avail themselves of new and exciting financing markets. As a result, as more and more corporates align themselves, for example, to certain climate and carbon metrics, what follows are projects to invest in that need to be funded for which the green bond market is the obvious tool.

Additionally, as companies then chart out their decarbonization journeys, KPIs are created that may then be utilized in SLB markets. Put another way, it's corporate climate and social commitments, those are what's driving volumes in ESG financing markets.

Liz Bowyer: So, Jonny, an ongoing concern for investors in this space is whether companies are really following through on their climate promises with real and tangible action. How are investors holding them accountable in this regard?

Jonny Fine: Look, investors are coming at this both from a top-down as well as a bottom-up perspective. Top down means that a number of investors want to understand, for example, how executive compensation is tied to the company reaching the ESG milestones. And if there is a designated member of the management team, who is responsible for setting the ESG agenda?

From a bottom-up perspective, there's clearly been a desire to see companies commit to nearer-term targets than, for example, net zero by 2050. As a result, we are seeing companies start to create interim targets that chart their path to 2050 or indeed different KPIs that might refer to specific decarbonization goals in the intervening period.

Companies are also responding to the investor ask for better and more fullsome disclosure -- i.e., better data disclosure frameworks like SASB and TCFD proliferate more and more.

There's also a growth in the use of ambitious targets that align with the SBT. But overall, accountability will be driven by cost of capital. If investors cannot drive the change they want through advocacy or indeed their votes where applicable then they will exit positions, and this will result in widening credit spreads and lower earning multiples. That's the endgame of accountability here.

Liz Bowyer: Well, the White House is hosting a climate summit in the next couple of weeks. How, if at all, is the Biden administration's focus on climate and sustainability issues affecting the way clients think about their own ESG efforts?

Jonny Fine: Yeah, that's really interesting, Liz. And I think if the last few years have taught us anything, it's that the private sector will step up in a meaningful way to address issues of global importance such as climate change and social justice even if, and perhaps especially if, the governing administration is not. One could argue that when the US pulled out of the Paris Climate Accord that this was the spark that ignited both investor and issuer focus on climate that might otherwise not have happened.

As of last week, for example, a third of professionally managed assets are now controlled by investment firms who have signed onto the Net Zero Managers Alliance. And many companies will argue that they are already exactly where or are trending to where a climate-focused administration such as the current one would want them to be. All of this has happened in the last several years despite those headwinds coming from Washington.

Liz Bowyer: Well, continuing on the topic of clients, many of which have a global footprint and an important role to play in the transition to a carbon-zero environment, how are you helping them think about their own decarbonization journeys?

Jonny Fine: Firstly, it always starts with markets and investors as that's what drives cost of capital. Almost all our client conversations start with how investor capital has and continues to be mobilized in an ESG-forward now and what the implications of that might be. We already see cost-of-capital differences in ESG fixed income financing markets such as the green bonds and social bonds we discussed earlier. Now we are starting to see these cost-of-capital differences play out based upon companies' carbon footprints, often encapsulated in ESG scores, for example.

Clearly no client wants to see them excluded from key investment portfolios. Nor do they want to see agitation from investors that could result in unwanted voting outcomes. So from a decarbonization journey, we are really looking to help companies find ways to more meaningfully reduce the carbon intensity of their business, really looking at the full range of solutions that Goldman Sachs can offer across the firm. And also to help finance this journey from an equity, structured finance, and capital markets perspective.

Liz Bowyer: So John Goldstein, the head of our sustainable finance group at Goldman Sachs, has said that 2020 is the year when ESG moved from the periphery to the core for our clients and investors. How have you seen that play out in terms of financing activity?

Jonny Fine: So completely agree with John and I've certainly heard him say that two or three or ten times. But ESG as a topic has clearly become more advanced, and it now needs to become much more bespoke for each and every client. Maybe a few years ago in the US there were standard ESG 101 materials and discussions we could have with our clients. But now different industries and different companies within those industries are all at very different stages of their ESG journeys. So we've morphed from explaining to clients what is happening from a regulatory disclosure and industry practices perspective to one now where we're providing holistic advice on how clients can implement or advance their ESG strategy that may lead to multiple opportunities including accelerating decarbonization plans, creating financing solutions for those plans, or issuing debt in the established ESG financing markets.

ESG has also become part of a large number of traditional advisory conversations we have with clients. It's no longer a specialist subject in that regard. For example, ESG is a central component of the IPO pitch. Founders and management teams care about maximizing demand from ESG investors, optimizing metrics, and understanding what disclosure frameworks to use. They want to communicate the sustainability goals to the broad public markets. As a result, we had to expand our own capabilities and to drive real scale of client discourse to ensure that we remain ahead of the curve.

Liz Bowyer: And how do you expect this activity to evolve in the next, say, 3-5 years?

Jonny Fine: So, Liz, I think there's a couple of phases that are going to play out over the course of that timeline. I mean, right now I'd say that we're at the early or middle stage of Phase 1. That's rapid growth in specific ESG financing markets such as those that we're seeing in the investment-grade and high-yield bond markets both here as well as in Europe as well.

We are also seeing nascent activity in convertible bond markets. We expect ECM to follow suit as well. So Phase 1 I think will be defined by more financing in more places and in more markets.

Now, Phase 2, which in all truth is happening in parallel, is actually all about the company and not about the financing product. Corporations, for example, that have a really robust decarbonization KPI, they won't need to issue a sustainability-linked bond to get a cost-of-capital advantage. Money is going to flow to them anyway. The existence of the KPI itself will differentiate that company's multiple and credit spread versus their peers that have less robust KPIs.

This is why ESG is not about products. It's all about companies.

Liz Bowyer: So finally, Jonny, with the shift of ESG from the periphery to the core, how are you advising clients on how to think about the risks and opportunities in this space?

Jonny Fine: Well, first of all, it's clearly a must-have discussion with every client in every industry. This is no longer the purview of natural resources. It impacts every industry group and every client that we speak to in each of those industry groups.

So firstly, when we think about constructing that dialogue with clients, we first think about what their left-tail risks are. What are they doing now? What could they be doing in the future that could create negative ESG outcomes for the company and thus create cost-of-capital dislocations and broader stakeholder disquiet? That's really looking at understanding parts of the business that could result in screening out or, for example, contribute to low ESG scores.

Essentially what we're doing here is identifying client vulnerabilities and ensuring that there's a plan in action as a result. This requires a really foundational analysis that, again, is very bespoke for each individual company, each individual industry but can be a very powerful tool for management teams and their boards to understand how to position for the coming years.

There are also enormous right-tail opportunities. These can include decarbonization capital deployment. For example, into renewables or forestry. Also, inorganic growth opportunities via M&A or even incorporating an ESG overlay into liquidity and short-duration investment strategies.

Liz Bowyer: Thanks, Jonny.

Jonny Fine: Liz, thank you very much for having me back on again.