**NOMURA**
*Connecting Markets East & West*

# More important than ever: Why ESG investment will remain crucial

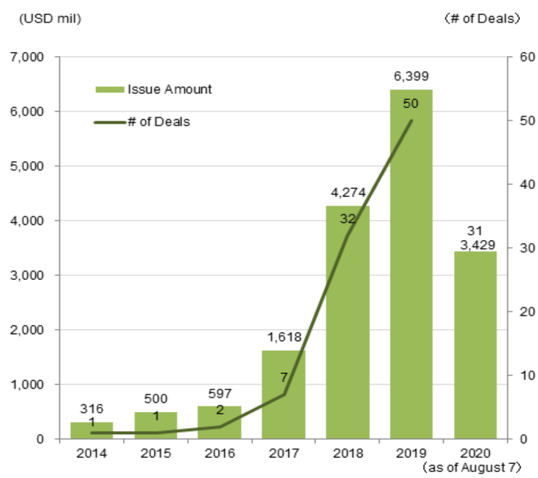
When Typhoon Hagibis cut a swath of destruction across Japan in October 2019, it was the latest and most powerful wakeup call for Japan's residents that the ravages of climate change were hitting closer to home.

The killer storm, following years of devastating flooding in southern Japan, boosted already mounting Japanese interest in green bonds — for which the proceeds are used to finance environmentally sustainable projects - both as drivers of positive impact and long-term risk management.

After years trailing Europe, ESG investment in Japan is taking off, attracting intense demand from institutional investors such as pension funds and life insurers. The trend is being led by the Government Pension Investment Fund (GPIF) — by most measures the world's biggest pension fund, with roughly US$1.5 trillion in assets under management.

In 2019, GPIF made a game-changing pivot to ESG bonds, investing more than US$3 billion in green, social and sustainability bonds in one year alone. Overall last year, Japan saw a record 50 green bond issuances worth US$6.34 billion — compared to just one issuance worth $315 million five years before.

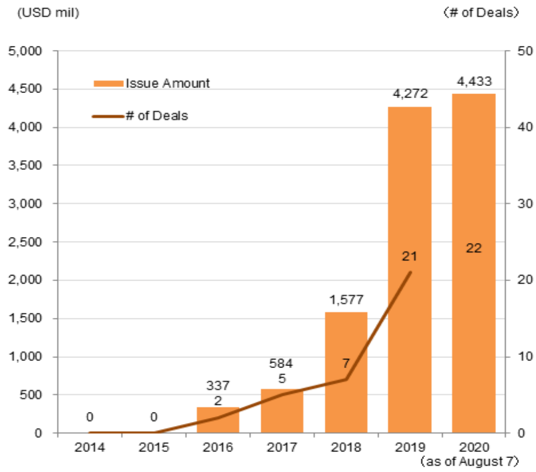
### Annual issuance record by Japanese issuers: green bonds




*Source: CAPITAL EYE*

Meanwhile, Japan last year tripled the number of social bond issuances from 6 to 18, with the value nearly quadrupling from US$1.09 billion to US$4.2 billion. Social bonds differ from green bonds by seeking positive social rather than environmental benefits, for example promoting financial inclusion, better education, quality healthcare, affordable housing, food security or employment generation.

### Annual issuance record by Japanese issuers: social bonds




*Source: CAPITAL EYE*

***"Both green and social bond issuances in Japan have been growing rapidly over the past year,"*** says Kazuyuki Aihara, Head of ESG products, Debt Capital Markets, Nomura. ***"But market volume is still small compared to the size of Japan's GDP. In other words, there's still great untapped potential."***

Japan's rapid green bond growth, Aihara says, is being led by investors big and small, reflecting a long-term societal shift rather than a short-term fad: ***"Due to events such as Typhoon Hagibis, Japanese people are awakening to the fact that global warming is at their doorstep," he says. "Today's investors see a massive stake in investing in green and social sustainability products."***

## Innovation for impact

One of the most powerful ways of fostering impact, as well as return, is investment in game-changing green technologies, from electric vehicles to smart cities and clean water systems. A critical piece of this innovation picture, however, is also imaginative green financing solutions.

According to APEC, ESG financing has moved from a simple model of banks extending green loans to a highly diversified range of methods and products — including green bonds, private equity, green insurance, and M&A. To preserve the planet, a combination of breakthrough technologies and innovative financing instruments is required, the latter fuelling the former.

Picking the right approach for each situation requires a high level of expertise, to optimise potential for both impact and return. One such example came in 2018, when Nomura served as bookrunner for the world's first green bond in global shipping, enabling Japan's NYK Line to partially decarbonise shipping by building LNG-fuelled vessels.

Underscoring its expertise in Europe, the centre of the ESG investment market, in July 2020 Nomura acted as a lead arranger of de Volksbank's €500m green bond – the first ever Tier 2 capital instrument in ESG format from any European bank. Separately, last year Nomura acted as bookrunner for a €2.25 billion sustainability bond for the German state of North Rhine-Westphalia – at the time the largest sustainability bond ever.

Now Nomura intends to accelerate its mission of merging innovative tech with smart financing through its acquisition of Greentech Capital Advisors, a global leader in green innovation M&A (see box). ***"The deal, which closed at the end of March 2020, is already delivering synergies between Greentech's green innovation acumen and Nomura's sophisticated debt structuring capabilities, as well as its access to Asian markets: This will be transformational"*** says Jarek Olszowka, Head of Sustainable Finance at Nomura.

Jeff McDermott, founder of the company and now Head of Nomura Greentech, echoes this sentiment. ***"Becoming a part of Nomura enables us to bring more value to our clients by delivering integrated capital markets and financing solutions to them, and through leveraging Nomura's excellent relationships with Asian based companies and investors."***

## Transition bonds: a novel approach

Despite the proliferation of interest in both ESG technology and financing, it might be too much to expect certain companies to be able to change their operating models or install novel entirely green technologies overnight.

Transition bonds are an important innovation in ESG investment that seeks to address this. They are designed to help carbon-intensive industries transition towards low carbon business models. The idea is for the debt to be issued by companies from industries that are "brown" today but aspire to transition to green practices, or at least become "less brown."

Examples of such debt include securities issued to fund a switch from coal to gas in defined geographical zones, or technology that converts industrial waste into clean energy. To obtain transition bonds, the issuer must commit to shifting to more sustainable business practices — although one concern is that there are not yet established guidelines on what exactly that means.

Nomura, together with other leading market participants, is working as part of the ICMA Climate Transition Finance Working Group to develop these much needed "rules of the road".

Sustainability-linked bonds are another interesting ESG instrument on the horizon. These do not require the ring-fencing or earmarking of bond proceeds to eligible green or social projects (the cornerstone of green, social and sustainability bonds). Rather, their financial and structural characteristics vary depending on whether the issuer achieves a predefined sustainability or ESG objective.

Through these bonds, issuers are committing to future improvements in sustainability outcomes within a set timeline. They are therefore forward-looking performance-based instruments, where the outcomes are measured through predefined key performance indicators and assessed against agreed Sustainability Performance Targets.

***"The main benefit of this novel instrument is that it will widen the ESG issuer universe, allowing companies that do not necessarily have sufficient green or social assets to issue a traditional green or social bond to work on improving their overall sustainability profile"*** says Olszowka.

One intriguing example of such a sustainability-linked bond was issued last year by Italian energy giant Enel. The instrument promises to increase its coupon by 25 basis points per annum if the company does not meet its target for increasing renewables to 55% of total capacity by the end of 2021. Enel has certainly achieved an upfront pricing benefit thanks to applying this new sustainability-linked bond format.

While such approaches can raise potential controversies, with some arguing they lend a "halo effect" to not-so-green industries, Olszowka says a more pragmatic approach may be needed to ensure a healthy world for future generations.

***"Green bonds simply aren't enough to give us a shot at meeting the Paris Accord climate goals," he argues. "We really do need to also involve the higher carbon emitting industries and help them transition. However, this needs to be done with appropriate safeguards in place to ensure there is no 'transition-washing' and that the goals set are meaningful, sufficiently ambitious and capable of being monitored and verified."***

It's a view championed by former Bank of England governor Mark Carney, who calls for "50 shades of green," or a multi-pronged approach to climate mitigation, to conquer the biggest challenge our planet confronts today.

Meanwhile, research interest is growing fast in approaches that look beyond binary "black-and-white" classifications: "Advocates of transition bonds suggest that it is better for companies aspiring to become 'greener' to finance their assets using transition bonds, rather than be excluded from the green bond market without an alternative source of funding to support transition projects," according to Ryan Riordan, Director of Research at the Institute for Sustainable Finance, at Canada's Smith School of Business.

## Green alpha in developing Asia?

Even as interest in green and social bonds proliferates, one of the persistent challenges the sector faces is low yield, since most issuers are investment grade.

Much of today's huge appetite for green instruments is that they maintain value — since most ESG investors favour more of a "buy-to-hold" strategy — and are therefore good risk-management instruments for pension funds and other asset owners. (This was apparent during the recent Covid-19-related market sell-off, where ESG bonds tended to outperform their conventional counterparts in the secondary market.)

But the dearth of alpha in the green market remains a persistent concern. Issuing green bonds is more expensive than ordinary bonds, due to consultancy fees, third-party verification, and monitoring impact. ***"So issuers prefer to offset that expense by being able to achieve a slightly lower coupon,"*** Aihara explains.

One potential avenue for balancing long-term value in a green bond portfolio with competitive yield is looking to Southeast Asian nations such as Indonesia, Vietnam, the Philippines and Thailand. It's a way to inject some "juice" into the equation and achieve a yield pick-up, says Olszowka, while fostering the aspirational journey of these countries in a way that does not end in climate tragedy.

***"Investors want diversification, in terms of geography, type of issuer, type of sector as well. And they also want to see lower-rated issuers," says Olszowka. "If you're a portfolio manager and you're running a green bond fund, you're trying to beat somebenchmark, let's say a specific green bond index. It's a bit hard if you're forced to buy only triple-A and double-A rated paper, and this paper also happens to constitute the majority of the index you are trying to beat. Also, buying a wider array of types of ESG bonds that are being issued will allow portfolio managers to construct more diverse investing strategies and in turn help satisfy the increasingly diverse and more nuanced ESG views of asset owners."***

As the largest shareholder in the Asian Development Bank (with a 15.6% stake), Japan plays an outsized role in promoting the narrative of sustainable growth in emerging Asia. Nomura is well-placed to play a leading role in this adventure through green financing, due to its historical presence in Southeast Asia and unrivalled experience underwriting projects in the region.

***"Demand for renewable energy and clean technology won't be confined to China and India," says Olszowka. "There will also be rising demand in other economies with fast-growing populations, which require huge investment in infrastructure such as the Philippines, Indonesia and Vietnam."***

## COVID-19 and ESG's future

Without a doubt, the coronavirus crisis and its devastating economic and social impact has resulted in a temporary slowdown in the promising discourse surrounding green investments, in particular in the initial stages of the lockdown. The first half of 2020 has seen a drop in green bond issuance:, global green bond issuance fell by 8% compared to the first half of 2019, totalling USD119 billion.

Olszowka believes that this slowdown is a result of governments and corporates focusing on the immediate need to repair social and economic dislocations and to mitigate the adverse impact of the COVID-19 pandemic, with climate mitigation and adaptation efforts taking a temporary backseat.

However, Nomura sees long-term ESG opportunities springing from the pandemic, for example in promoting solutions to global health challenges and societal disruption. Even in the short-term, Olszowka says, the massive stimulus packages launched by the US, Japan, EU and others can be expected to spark a flurry of activity in social and sustainability bonds, even if the green sector will remain subdued for the time being.

Evidence for this is already apparent in a surge in social bond issuance, which grew by an astonishing 376% in 1H 2020 from 1H 2019, totalling USD41.9 billion. So far in 2020 the value of such bonds has exceeded the total raised by social bonds in all previous years combined.

Nomura has been very active in assisting clients in their response efforts to the pandemic, underwriting a number of landmark Covid-19 response bonds such as BBVA's Euro 1 billion social bond, the first such bond from a European financial institution, as well as the World Bank's USD4 billion and IADB's USD4.25 billion Sustainable Development Bonds – all issued in the fight to help mitigate the impact of the COVID-19 virus.

Aihara predicts that the COVID-19 crisis will ultimately galvanise global opinion on the need for investment that promotes social good: ***"When this crisis is over, investors in the market are likely to have greater consideration for sustainability in society," he says, "and prefer to invest in such products as green bonds or social bonds."***

## Nomura's commitment

Nomura is committed to the principle that ESG investment is a powerful vehicle to spark a "virtuous cycle" in society, laying the conditions for long-term sustainable growth. In the words of legendary conservationist David Brower, founder of Friends of the Earth: "There is no business on a dead planet."

Through its global reach, Nomura seeks to foster the positive dynamic currently underway in Japan, in which the custodians of society's financial security — its pension funds — converge on the logic of entrusting their staggeringly large assets to green vehicles. In fact, GPIF no longer refers to its ESG investments as being "long-term" (a timeframe defined by market players as 1-5 years). It now prefers to speak of "cross-generational" ESG investing.

***"By changing the world for the better, investors can get a better performance in the long-term from their funds," says Aihara. "That is the view of the 'universal owner' — in order to keep the market growing, and the economy growing, it's essential to keep the world healthy. That's the key challenge we face today."***

**Nomura Leading the Way**

With a Japanese home and global reach, Nomura is uniquely positioned to play a leading role in Japan's thriving market for green bonds — serving as a bridge between East and West to connect stakeholders at this new frontier of ESG engagement.

***"We can leverage cultural synergies and communication power to build the green bond industry,"*** says Kazuyuki Aihara, Head of the Sustainability Finance Section in Nomura's Debt Capital Markets Department.

Nomura has a proud history of embracing responsible investment approaches before they became fashionable. The brokerage began lead-arranging global ESG debt in 2010, early days in the green bond market. Its history means it can demonstrate both genuine commitment and deep experience in charting new responsible investment paths for global investors.

Nomura is today committed to taking this pioneering role into new directions. In 2018, for example, it served as bookrunner for Japan's first green corporate bond for a construction company. Obayashi Corp's 5-year bond is now funding self-elevating platform vessels for solar power plants, onshore wind power facilities, and green buildings.

Last year was a breakthrough year in Nomura's ESG investment evolution. Achievements include:

- Selection as one of five underwriters appointed to the International Capital Markets Association's new advisory council for green and social bond principles;
- Runner-up finish in Global Capital's awards for most impressive Asia-Pacific bank for green and SRI (socially responsible investment) capital markets;
- Launch of a new ESG sub-index in Japan — an SDG version of the Nomura Bond Performance Index, one of the most widely followed benchmarks in the domestic bond market.
- The establishment of the new Nomura Institute of Capital Market Research's Research Center of Sustainability, and publication of bestselling book on the Age of Sustainable Finance.

And Nomura has now entered 2020 with one of its most significant moves yet in ESG investment leadership: acquisition of Greentech Capital Advisors. The world's leading eco-innovation M&A advisory, Greentech has extensive expertise in advanced transportation, renewable energy, clean water systems, Industrial IoT, smart infrastructure, and more.

For two consecutive years, Bloomberg has ranked Greentech as the No. 1 Clean Energy Technology M&A advisor — with three times as many transactions as its closest competitor.

Nomura's largest acquisition since 2008 arms it with global tech investment expertise that combines with its access to Asian markets — and innovative debt structuring acumen — to open a world of new green investment possibility.

***"Our extensive franchise across Asia and elsewhere means we can also help Greentech to expand internationally," says Jarek Olszowka, Head of Sustainable Finance at Nomura. "So there are considerable synergies to be generated from the deal."***

In announcing the acquisition, Nomura's new GCEO Kentaro Okuda emphasised how the deal enables the bank to boost its unique role in "connecting markets east and west… Combined with the establishment of Nomura Institute of Capital Market Research's Research Center of Sustainability it shows our commitment towards the sustainable development of society."

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