

# Sustainability-Linked Bonds Evaluation Criteria



Credit  
Rating  
Agency

HR Sustainable Impact  
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This document describes the evaluation process for Sustainability-Linked Bonds, which are defined as those seeking to achieve pre-defined sustainability objectives or objectives aimed at improving the issuer's environmental, social or corporate governance (ESG) practices. These bonds have predefined Key performance indicators (KPIs) to measure progress towards sustainability performance targets (SPTs). Structural and/or financial characteristics usually change when the objectives set by the issuers are not met.

The evaluation proposed here is not a credit rating, but rather refers to the assignment of a "Favorable" or "Unfavorable" opinion.

The analysis hinges on three pillars:

1. The first, and most important pillar, analyzes compliance with the five components identified by the ICMA<sup>1</sup> in its Sustainability-Linked Bond Principles.<sup>2</sup> Local market standards, if applicable, may be considered to the extent that they expand on the above requirements.
2. The second focuses on the way in which the objectives established in the reference framework and/or bonds are aligned with the company's comprehensive sustainability strategy.
3. Finally, the third pillar is based on evaluating the impact or importance of STP objectives considering local context and the relevant industry.

HR Ratings may assign differentiated levels to a reference framework and its related bonds. This will involve assessing the extent to which the bonds adhere to the evaluated reference framework, as well as impact and compliance with selected KPIs and SPTs. In these cases, the level assigned to the reference framework will function as a benchmark for the evaluation of its associated bonds and its levels may fluctuate according to the analysis applied to each one in a particular way in adherence to the process set out in this methodology. In the event that the evaluation is only applied to the reference framework and the evaluation of the bonds linked to it is not requested, it will be the responsibility of the interested parties to ensure compliance and potential impacts.

<sup>1</sup> International Capital Market Association (ICMA)

<sup>2</sup> The version of the principles in force at the time of the analysis will be used.



The evaluations described in this document do not offer any opinion on the credit quality of the bond or the entity. HR Ratings may use public or private sources of information to conduct its evaluation.

## Introduction

Sustainability-linked bonds have structural or financial characteristics that may vary depending on whether the entity meets its operation's ESG practices and sustainability-related objectives. The main difference, when comparing them to other sustainable market bonds, is that the funds raised are for the entity's general use and the objectives are determined by the entity itself. Therefore, the applied analysis must focus on the entity's general sustainability strategy and how the bond is aligned with achieving this strategy.

This document is the exclusive property of HR Ratings, and it substitutes the document "Evaluation Criteria for Sustainable Bonds and Sustainability Linked Bonds" published in December 2021. This document becomes applicable after October 31, 2024.

## Compliance with the components of the Sustainability-Linked Bond Principles

The framework, and/or bonds, should be aligned with the Sustainability-Linked Bond Principles established by the ICMA. The five principles include: 1) Selection of key performance indicators (KPIs), 2) Calibration of sustainability performance targets (SPTs), 3) Bond characteristics, 4) Reporting, and 5) Verification.

### 1) Selection of Key Performance Indicators (KPIs)

The entity may select one or more KPIs to track its progress towards the sustainability objectives stated in the bond documentation. Bond credibility depends on KPI credibility and relevance, which is why HR Ratings will evaluate the KPIs as follows:

- KPIs should be relevant to the entity's sustainability strategy. Addressing environmental, social and/or governance objectives that are material to the entity's context and profile.
- KPIs must be clearly defined and have consistent methodologies to facilitate reviewing their composition.
- To the extent possible, KPIs must be comparable with third parties or with external references in order to evaluate ambition levels.
- The entity shall provide at least three years of historical levels for the selected KPIs.<sup>3</sup>
- The entity must show its technical capacity to carry out the calculation and monitor KPIs by formally defining the required tools in its internal manuals and processes.

KPI selection must consider local market guidelines, as applicable. In Mexico for example, the selection must consider the targets and measurements established in the *Mexican Sustainable Taxonomy*. This evaluation will consider industry practices, regulations and guidelines in force at the time of the evaluation.

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<sup>3</sup> In cases where historical externally verified KPI values have not been previously calculated, the entity must provide, to the extent possible, an approximation of such values.



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The evaluation results for each selected KPI will be assigned one of the following levels: "Very Strong", "Strong", "Adequate", or "Not Aligned".

**Figure 1. KPI evaluation results**

Very Strong	The KPI addresses issues relevant to the entity's sustainability strategy. It is clearly defined in methodologies of use that allow the review of its construction. The kpi is comparable with relevant third parties and includes at least three years of historical information that can be used to evaluate its performance. The selected kpi is in line with the recommendations of local and/or global taxonomies according to the economic activity or industry in which the company participates.
Strong	The KPI addresses issues relevant to the entity's sustainability strategy. It is clearly defined in methodologies of use that allow the review of its construction. The kpi is comparable with relevant third parties or with target levels endorsed by the scientific community. However, there is no historical information to evaluate the company's performance. The selected kpi is in line with the recommendations of local and/or global taxonomies according to the economic activity or industry in which the company participates.
Adequate	The KPI addresses issues relevant to the entity's sustainability strategy. The construction of the kpi is consistent, however, it is not formalized within a clear methodology that facilitates its review. The kpi is comparable with relevant third parties or with target levels endorsed by the scientific community. However, there is no historical information to evaluate the company's performance. The selected kpi is in line with the recommendations of local and/or global taxonomies according to the economic activity or industry in which the company participates.
Not Aligned	The KPI does not address issues relevant to the entity's sustainability strategy. The construction of the KPI is inconsistent as it is not formalized within a clear methodology that facilitates its review. The kpi does not offer a basis for comparison to be evaluated. The selected kpi is not in line with the recommendations of local and/or global taxonomies according to the economic activity or industry in which the company participates.

Source: HR Ratings

## 2) Calibration of Sustainability Performance Targets (SPTs)

A Sustainability Performance Target, or SPT, should be defined for each selected KPI. The calibration of each of these SPTs will have to establish goals that are both realistic, taking into account the entity's profile and context, and ambitious, i.e., improvements over the level of progress that would be achieved under the entity's current operating conditions. HR Ratings' review will cover the following:

- SPTs must be congruent with the entity's sustainability strategy.
- SPTs must represent a material improvement over levels that would be achievable under the entity's current operations.
- SPTs must be defined considering comparable benchmarks: whether it is an improvement over the entity's own historical levels, its level in relation to its competitors or applicable industry standards, or its level in relation to targets set by the scientific community.



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- The entity must establish its strategy to ensure compliance with SPTs, including specific dates or a timeline that establishes initial expectations regarding changes in its performance.
- The entity must clearly report when there are changes in how SPTs are calculated or adjustments to the established targets.
- The entity must inform how it will obtain the SPTs while considering competence and confidentiality, as well as
- report any externalities that could possibly affect eventual compliance with SPTs.

SPT selection must consider local market guidelines, as applicable. In Mexico for example, the selection must consider the targets and measurements established in the *Mexican Sustainable Taxonomy*. This evaluation will consider industry practices, regulations and guidelines in force at the time of the evaluation.

The evaluation results for each selected SPT will be assigned one of the following levels: "Very Strong", "Strong", "Adequate", or "Not Aligned".

**Figure 2. SPT evaluation results**

Very Strong	The SPT is consistent with the objectives established in the company's sustainability strategy. The SPT presents a material improvement in line with the goals established by international organizations for participants in the sector. The SPT has a comparative basis for assessing progress at different review points. The company has a clear strategy for achieving the targets as well as the necessary monitoring and reporting systems to update stakeholders on any progress or modifications in a timely manner.
Strong	The SPT is consistent with the objectives established in the company's sustainability strategy. The SPT presents a significant improvement over the levels of progress that would be achieved by continuing with the operation under its current conditions. The SPT has a comparative basis for evaluating the progress achieved at different review points. The company has a clear strategy for achieving the objectives as well as the necessary monitoring and reporting systems to update stakeholders on any progress or modifications in a timely manner.
Adequate	The SPT is consistent with the objectives established in the company's sustainability strategy. The SPT presents a slight improvement over the levels of progress that would be achieved by continuing with the operation under its current conditions. The SPT has a comparative basis for evaluating progress. However, it is not clear how often it will be reviewed. The company has a clear strategy for achieving the objectives as well as the necessary monitoring and reporting systems to update stakeholders on any progress or modifications in a timely manner.
Not Aligned	The SPT is not consistent with the objectives established in the company's sustainability strategy. The SPT does not represent an improvement over the levels of progress that would be achieved by continuing with the operation under its current conditions. The SPT does not have a comparative basis for evaluating the progress achieved at different review points. The company does not have a clear strategy for achieving the objectives, nor does it have the monitoring and reporting systems necessary to update stakeholders of any progress or modifications in a timely manner.

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### 3) Bond characteristics

A key point about sustainability-linked bonds is that financial conditions are affected by performance towards the targets set. Failure to meet STP targets or objectives results in a negative financial impact on the initial bond conditions. For example, one of the most common effects is the increase in the level of the applicable surcharge. However, in some cases, an outstanding performance that even exceeds the targets set may improve the bond's financial conditions, for example, a reduction in the surcharge.

HR Ratings will evaluate the expected level of impact of the possible variation in financial conditions tied to the SPTs. Where preferably, there should be a proportional variation on the initial financing cost and a significant difference between the bond conditions when the targets are met and the bond conditions when the agreed targets are not met.

### 4) Reporting

The entity will publish and maintain reports that address KPI performance or potential changes to the SPTs. These reports are relevant as they will allow investors to understand movements regarding the financial or initial structural conditions of the evaluated bond, and they should preferably be accessible to the public through different means. The evaluation will be based on the following:

- Information quality pertaining to KPI performance. Must be complete and timely to ensure ease of monitoring by interested parties.
- Information quality in terms of SPT performance reporting. This must include, if necessary, information on any possible impact on the bonds' financial or structural conditions.
- Publication frequency, preferably updated annually.
- Any information necessary to effectively monitor the entity's noncompliance and progress toward bond targets must be disclosed.
- Any information that allows investors to monitor SPT ambition levels.

### 5) Verification

The entity must obtain external and independent verification of performance levels against each SPT established for each KPI. This verification should be performed by a third party qualified for the respective studies.

Verification results will be reported to the market at least once a year or if there is a structural and/or financial impact on the bonds.

## Impact analysis of selected SPTs

This analysis will detail the importance of the goals established in the SPTs concerning the entity's local context. Impacts may be environmental and/or social in nature and should represent progress towards one of the goals established in the SDGs or, if applicable, goals established per local guidelines.



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The analysis may vary depending on whether it is applied to a pre-placement reference framework or whether the analysis is applied to the monitoring of an already placed bond. The main difference is that in the case of a pre-placement analysis, the evaluation will be based on the expected impact, while the evaluation for the latter may also consider post-bond placement performance.

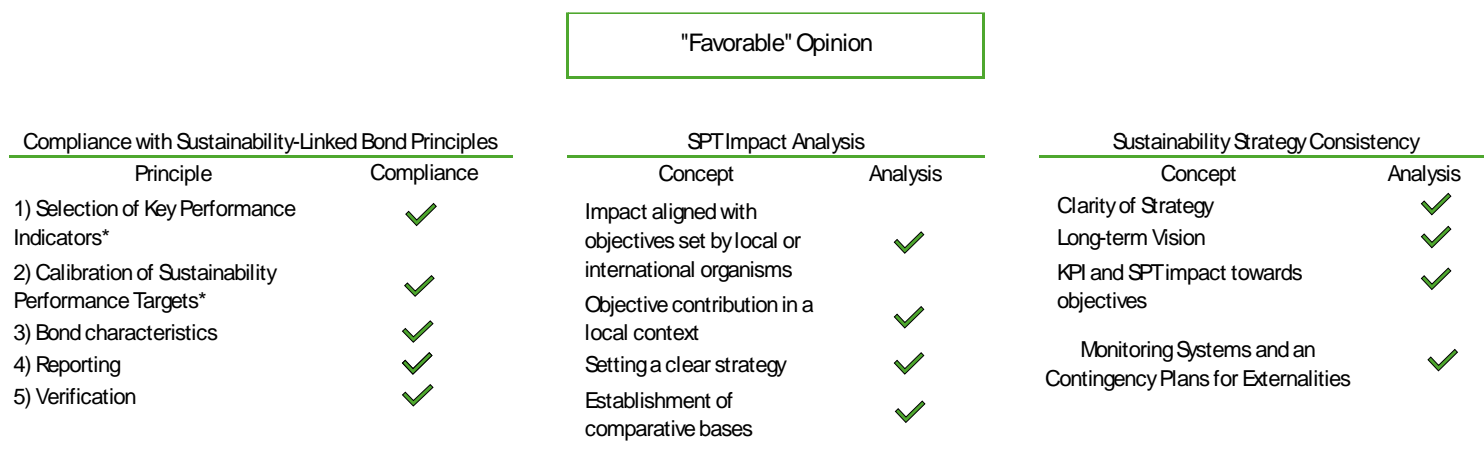
## Sustainability strategy consistency analysis

Sustainability-linked bonds will drive the targets established in the entity's sustainability strategy. The company's sustainability strategy must establish a comprehensive and long-term vision of how the entity intends to achieve its environmental and social targets according to its industry and local context. The strategy must also include a monitoring and mitigation plan for any possible negative externalities arising from its activities. In this regard, the bonds will be understood as a tool that helps the company progress towards its sustainability goals.

## Evaluation Process

The bonds will be evaluated based on the principles established for each of the three pillars. In other words, each evaluation must conclude that the bond duly complies with the applicable principles, the impact analysis, and the entity's sustainability strategy consistency analysis. A "Favorable" opinion means that the bond complies with the STPs applicable principles and impact analysis, while the sustainability strategy consistency analysis is offered as a complement to provide further information to the market. In other words, failure to comply with any of the items evaluated in the first two pillars will result in an "Unfavorable" rating.

**Figure 3. Evaluation Structure**



Source: HRRatings

\* KPIs & SPTs must get a result of "Adequate", "Strong", "Very Strong".

The figure shows the structure of an evaluation that was assigned a "Favorable" opinion. The first pillar is analyzed in terms of compliance with its principles. The first two principles (Selection of key performance indicators, Calibration of sustainability performance targets) must be considered "Adequate", "Strong" or "Very Strong" to receive a Favorable opinion. The distinction of these results meets the objective of informing the market of the strength of the instrument above the minimum necessary



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requirement. The rest of the principles will be evaluated under a binary outcome with any non-compliance leading to an "Unfavorable" opinion.

The SPT impact analysis may vary from case to case. In general, SPTs are expected to establish targets in line with the progress plans established by local or international organizations in order to contribute to environmental and/or social purposes, as applicable. When setting the goals or objectives, the SPTs must always consider the local context of its region of operation. They must also include a clear strategy and a comparative basis to measure progress at different review points. In tandem, these items will determine whether the SPTs are sufficiently robust to support being assigned a "Favorable" opinion.

Finally, the analysis of the third pillar will focus on whether the SPTs contribute to the company's sustainable strategy. That is, the company placing the linked bonds must have a formalized strategy with a clear long-term outlook in its internal policies in order to evaluate its progress towards such targets. Unlike the other pillars, the evaluation of consistency with the sustainability strategy will not necessarily affect the opinion on the bonds. Its aim is to provide further information for the market on the company's progress in developing a sustainable strategy and/or the ambition and completeness of existing and regularly updated strategies. If there is already a strategy in place, KPIs and SPTs will represent progress on reaching the targets set.



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