EQUITIES

ESG in Equities: Identifying Winners in the Energy Transition

BARINGS INSIGHTS

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Clean energy and anti-pollution initiatives will continue to impact the equity investment landscape—but not all companies will be winners, and careful analysis will be needed to identify those that stand to benefit and those that may see a threat to their business model.

The global response to climate change has escalated in recent years, evidenced in part by the policy steps being taken by governments around the world. Within hours of being sworn in as the 46th U.S. president, for instance, Joe Biden signed an executive order to reaccept the Paris Agreement—thereby committing the U.S. to outlining climate actions, known as nationally determined contributions, and to pursue domestic mitigation measures aimed at achieving the objectives of such contributions. The European Commission announced the European Green Deal in December 2019, which aims to transform the region into a low-carbon economy by achieving carbon neutrality by 2050 and decoupling economic growth from resource use. And in China, Xi Jinping announced a pledge to make the world's biggest GHG emitter carbon neutral by 2060.

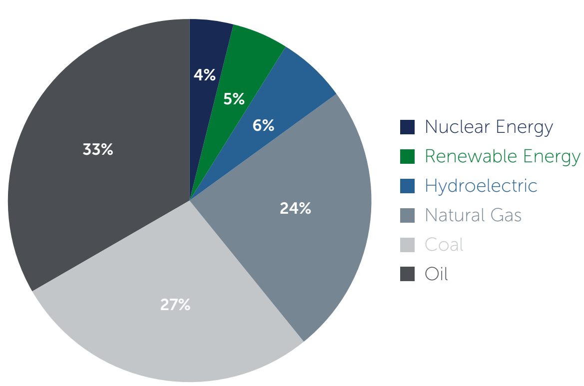
These commitments have already affected, and will likely continue to influence, the investment landscape, whether directly or indirectly. Indeed, Article 2 of the Paris Agreement calls for synchronizing investment flows with efforts to bring about low GHG emissions and climate-resilient developments. Companies that are directly or indirectly exposed to these trends will almost certainly be impacted as a result—but not all companies will be winners, and careful analysis will be needed to identify those that stand to benefit and those that may see a threat to their business model.

In this first piece of a new series on environmental, social and governance (ESG) in equities, we explore the potential opportunity created from increased investment in two key policy areas under the European Green Deal—clean energy and the elimination of pollution.

Clean Energy

Clean, renewable energy has been part of human civilization since ancient times. From Egyptians using wind power to sail their ships, to Persians using the first-known windmills and wind-powered water pumps around 500AD, the harvesting of renewable energy has been achieved in a variety of ways. Encouragingly, creativity in this space has not ceased. For instance, there are startup technologies, such as bladeless wind "turbines", that are a fraction of the cost of a traditional wind turbine and require far less space to install—providing a potential solution for densely populated areas, such as those in emerging markets. That said, decarbonizing the energy supply is no small task, especially considering that 84% of today's total energy supply comes from fossil fuels **(FIGURE 1)**.

FIGURE 1: Global Energy Supply by Source



SOURCE: BP. As of December 2019.

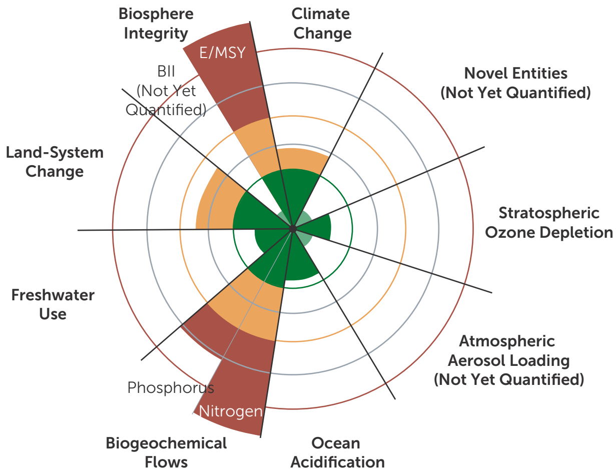
As we look across the landscape today, there are a wide array of companies involved in the transition to clean energy—from equipment manufacturers like Danish wind turbine manufacturer Vestas, to industrial gas manufacturers like Linde, which aims to supply clean hydrogen. Even some traditional energy suppliers are enabling the move to cleaner energy. For instance, Royal Dutch Shell is using hydrocarbon cash flows to invest in low carbon and energy transition businesses.

Companies that can materially contribute to the decarbonization of the environment may experience a tailwind going forward amid the growing push for a carbon neutral economy. Finnish company Neste, for example, produces a renewable diesel product that has helped its customers cut GHG emissions by up to 90% over the fuel's life cycle when compared with fossil diesel.[1] More recently, the company has developed a renewable aviation fuel with significant potential to help decarbonize aviation. At the same time, Neste is taking material steps to contribute to the circular economy, in this case through the production of renewable plastics and use of waste material as renewable feedstock.

Eliminating Pollution

In addition to underscoring the importance of clean energy initiatives, the EU Green Deal emphasizes the need to better monitor, prevent and rectify pollution from the air, water and soil. Complementary to this, the Stockholm Resilience Centre defines "biosphere integrity" as one of four components that are critical to the functioning of our planet and now to be deemed "high-risk" **(FIGURE 2)**. The Paris Agreement also stresses the importance of protecting and maintaining these systems, including oceans.

FIGURE 2: The Planetary Boundaries Framework



■ Below Boundary (Safe) ■ In Zone of Uncertainty (Increasing Risk) ■ Beyond Zone of Uncertainty (High Risk)

SOURCE: Steffen et al. As of 2015.

1. Source: Neste. As of September 2019.

As commitments to eliminating pollution and improving the earth's atmosphere strengthen, the range of solutions required to address each specific source of pollution will likely benefit a variety companies. In particular, companies that operate in niche/specialist areas that are too small to attract significant interest from new entrants, or those that are already well established in a specific field, may benefit the most. For example, Tomra Systems, which provides waste collecting solutions, may benefit from government pledges for capturing single-use plastics, as well as from food retailers turning positive on the company's reverse vending machines, which enable a consumer to exchange their used beverage bottles in return for cash.

Companies that make products to test water quality or to monitor pollution in the water or air may also stand to benefit. Halma is an example—the company has a long track record of providing health, safety and environmentally focused products, including some that are used to measure the shelf life of food to reduce waste and thereby prevent further pollution. At the same time, the company is taking steps to improve its own environmental credentials by reducing its carbon footprint.

Not Forgetting the S and the G

While analyzing companies from an environmental perspective offers visibility into how their revenue may fare in the face of evolving climate-focused initiatives, these considerations are only one factor in determining a company's attractiveness from an investment standpoint. Indeed, social and governance factors are equally paramount. For instance, a company that creates a product or service that solves one environmental problem—but does so at the expense of social, governance or even other environmental factors—may ultimately face significant challenges. And importantly, not all companies involved in the sustainability space will have sustainable business practices, which is why it is important for investors to conduct the necessary due diligence. In our view, companies with the following attributes look particularly well-positioned:

- **strong franchises**: for example, companies that manufacture products that contribute to a cleaner environment, while also taking steps to reduce their own carbon footprint
- **good management**: alignment with the long-term interests of minority shareholders
- **sustainable business practices**: no hidden E, S and G risks—including environmental fines or lawsuits related to business ethics—that pose a threat to financial stability

One of the better-known examples of environmental factors conflicting with social or other considerations relates to the use of palm oil in manufacturing. Very widely used in everything from food production to renewable fuel feedstock, palm oil has generated an abundance of negative headlines for its ties to issues like air pollution, deforestation and human trafficking. There are widespread and varying efforts underway to combat these issues. Again, Neste is an example—the company set up their own, EU Commission approved, sustainability verification system for palm oil in 2014 and are using sustainably-produced, 100% certified and 100% traceable palm oil as part of their renewable feedstock. The company has even committed to eliminating this sustainable palm oil altogether by 2024, while at the same time taking active steps to improve the fair treatment of workers in the palm oil industry. In our view, this is the type of progress and forward momentum that can ultimately help improve the discount rate required by investors and further unlock value.

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From a governance standpoint, factors such as the structure, diversity and independence of a company's board can be significant determining factors in a company's overall attractiveness. In the case of Neste, the board is 100% independent, with a roughly 40% female representation, and the roles of the CEO and chairman are split.[2] Companies like Halma, too, look sound from a governance perspective. While the company operates many subsidiaries, corporate governance appears to be strong. Female representation on the board has also remained at 40% over the past five years, but the ratio has notably improved at the executive board level from 13% to 45%.[3] And finally, the company has a group-wide whistleblowing policy that applies not only to its employees, but also to its joint venture partners, suppliers, customers and distributors.

Key Takeaway

Clean energy initiatives and policies—like the EU Green Deal—will impact the equity investment landscape for years to come. In the face of growing regulation, some companies look better positioned than others. In particular, those that are tackling or addressing pertinent climate issues head-on, while doing so with sustainable business practices, look likely to benefit, and could potentially command a higher premium in the market going forward versus peers with less favorable ESG dynamics.

At Barings, ESG analysis plays an integral role in our understanding of the potential risks and opportunities that a company faces, and in our investment decision-making. Our approach to ESG is anchored by three principles:

- integrating ESG factors into fundamental, bottom-up investment analysis
- taking a dynamic and forward-looking approach to analyzing a company's ESG factors
- actively engaging with management teams to improve ESG practices

We believe in engaging directly with corporate management teams to drive better ESG practices and improved disclosure, rather than relying on exclusion lists—which may fail to recognize the role certain, usually carbon-intensive industries play in achieving a sustainable future. In allowing us to quantify ESG risks and giving us a more comprehensive view of a company's future, this approach puts us in a position to deliver potentially superior risk-adjusted returns over time—as we seek to create a better outcome for people and the planet.

2. Source: Neste. As of February 2021.
3. Source: Halma. As of December 2020.

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