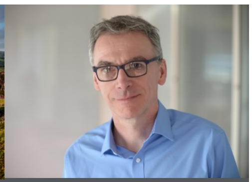
ESG Update



Fund Manager Commentary

Hugh Cuthbert | November 2021

Two Lost Years?

Global greenhouse gas emissions have been one of the few beneficiaries of the Covid-19 pandemic. As whole economies ground to a halt, industries curtailed or stopped production and miles travelled plummeted, the carbon pollution associated with these activities followed a similar path. An accurate measurement of the true impact is difficult but according to the Global Carbon Budget 2021 (figure 1), fossil carbon emissions dropped by 5.4% in 2021[1] . From a global warming perspective this can only be viewed as a positive but of course the impact is short lived and as economies have re-opened the situation has reversed. As fund managers there have been more practical difficulties posed by this phenomenon and these difficulties are longer term than the headline numbers might suggest.

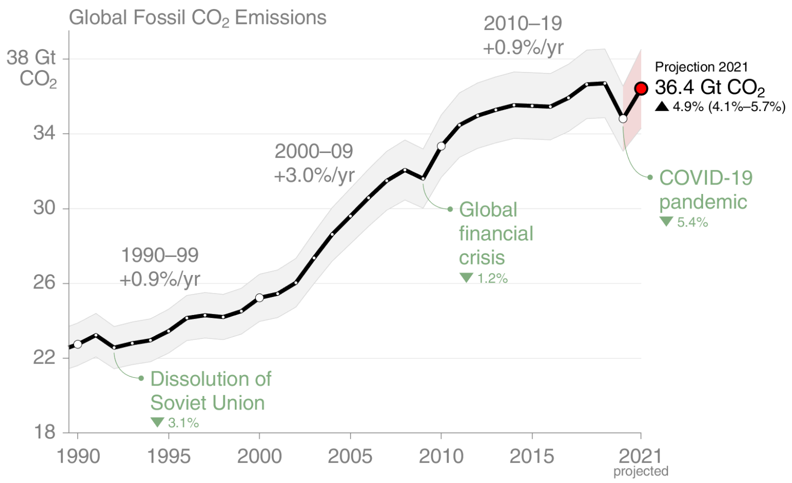


Figure 1. Source: Global Carbon Project

When scrutinising the emissions data of our investee companies for 2020 it is difficult not to find one whose environmental profile is improving. Only those industries who were able to keep producing their products or providing their services at a rate higher than 2019 were likely to have seen a deteriorating profile as far as greenhouse gases were concerned. A company forced to have their personnel working from home no longer had to heat their offices and provide other such services and instead the carbon burden was pushed to the individual homes of the workers concerned. Although this is something that should be embedded within a typical CO_2 analysis it makes what is already an inexact science even more open to dispute. Factories could either shut down or reduce the number of production lines, both of which would see a similar impact on their emissions profile.

Despite the drop in emissions, it is still difficult to conclude any kind of progress was made from an environmental perspective. Indeed, depending on your definition, even the absolute decline in greenhouse gases can be viewed in a negative light. As production volumes and or revenues have dropped companies have lost their economies of scale and just as this loss of efficiency impacts a company's profit margins the same often happens to its environmental efficiency. Carbon emitted per unit of production or € of revenue can be severely impacted by the loss in volumes. So, while CEO's may boast of their environmental progress, we must be careful of the specifics of their claims. Practically, however, such discussions have become very difficult. It is all but impossible to request proforma green house gas data which excludes the extraordinary effect of the pandemic. While extraordinary impacts are regularly excluded from financial data it is not a practice we regularly see for ESG metrics. 2020 therefore effectively becomes a lost year as far as credible discussions are concerned surrounding environmental progress for our investee companies.

The bad news is that 2021 will be equally difficult but for the opposite reason. As the impact of lockdowns have been reversed and industries have begun to refill inventories to cope with the resurgence in demand and workers have returned to their offices, absolute emissions will have soared. Perversely once we see company annual reports for the year the intensity metric will likely have improved allowing for claims of a greener organisation.

Whatever the case these two years are proving very difficult for proper analysis of the progress companies are making toward any targets they may have for emissions reduction or indeed net zero. We may have to wait until 2022 figures are published (which will not happen until 2023) to gain a true picture of where many companies stand.

To claim that the pandemic was beneficial to the environment is at best short termist and at worst simply wrong. As the discussions at COP 26 in Glasgow have made abundantly clear action needs to be taken fast to meet the 1.5°C ambitions of the Paris agreement. As investors we have a key role to play in these ambitions, but unfortunately recent events have made this a far from straight forward task and one severely hindered by these two lost years.

COP26 Engagement Highlights

As a continuing project we are contacting all our investee companies to ascertain their level of disclosure with regard to carbon reduction initiatives, and the timescales involved, as well as any potential alignment with the Paris Agreement and resultant net zero commitments that the companies may have. As a matter of process we record those already at net zero. This work has continued throughout October and November but has now also received official endorsement. The UK Chancellor, Rishi Sunak, has greatly abetted this process with his announcement to Cop-26 that the UK is to become the world's first net zero financial centre. Central to this announcement is the requirement for listed companies and larger private organisations to produce transition pathways toward this ambitious goal of net zero carbon emissions. While we welcome this move it is unlikely to stop our efforts on

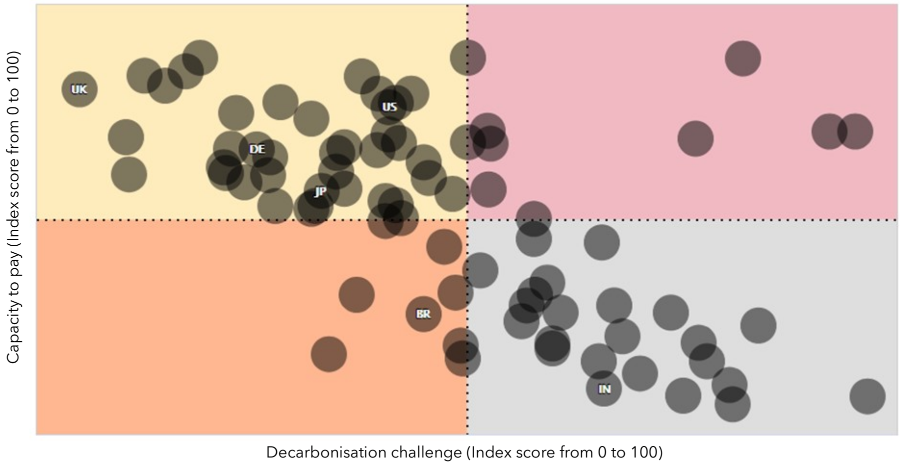
[1] Global Carbon Project – Global Carbon Budget 2021 - 4th November 2021 https://www.globalcarbonproject.org/carbonbudget/21/files/GCP_CarbonBudget_2021.pdf

this front any time soon as the government literature heralding the announcement states that "a science-based 'gold standard' for transition plans will be drawn up by a new Transition Plan Taskforce, composed of industry and academic leaders, regulators, and civil society groups." (Source; HM Treasury 3rd November 2021). This suggests it may be some time before we see these ambitions enacted so we will continue with our efforts in this area as before. Next month we will write on the rationale for this work and how it will help us align with the Chancellor's announcement.

Of further interest: Oxford economics research (figure 2) considers the challenge of decarbonising infrastructure, industry and transport which currently comprise 60% of global emissions. The UK is considered to have a strong capacity to finance the transition to net zero. However, the high levels of carbon emissions and existing infrastructure in need of radical transformation presents an unavoidable obstacle in fulfilling the requirements of the Paris Agreement.

[2] Achieving net-zero infrastructure - PwC - 29th October 2021 https://pwc.to/ANZInfra-tw

Green infrastructure transition: Decarbonisation challenge and capacity to pay



Top Left	Higher (but falling) CO2 emissions to abate Higher levels of existing infrastructure to transition to green Greater ability to afford	Top Right	Higher (but stabilising) CO2 emissions to abate Lower levels of existing infrastructure to transition to green Greater ability to afford
Bottom Left	Lower (but rising) CO2 emissions to abate Higher levels of existing infrastructure to transition to green Lower ability to afford	Bottom Right	Lower (but rising) CO2 emissions to abate Lower levels of existing infrastructure to transition to green Lower ability to afford

Figure 2. Source: PwC/Oxford

Featured Stocks

Norcross

Where a company operates on the basis of a holding structure with a number of subsidiaries this can present issues in terms of financial analysis, but, annual report and accounts do form the official basis for presenting the numbers to third parties. Unfortunately reporting structures, and indeed lines of command, are not necessarily so clear cut in terms of ESG data. Our engagements with this company have therefore focused upon more group wide ESG data becoming publicly available as well as, and perhaps more importantly, group wide standards and targets being set for the most material issues. Without such data it is very difficult to assess both the company ethos toward environmental, societal and governance issues as well as the inherent risks embedded within the operations. Announcements such as that made by Rishi Sunak detailed above are likely to help in what is an on-going engagement for us.

Alpha Financial

Through a combination of energy reduction initiatives, renewable energy purchases and carbon off-setting this company has become either a net zero emitter or very close to that status. We have written to the company requesting more clarity is given over this situation. We highlight this situation thanks to the highly exceptional nature of this request. It is considerably more common for engagement to centre on qualitative statements made without quantitative evidence to back them up so we are happy to encourage more disclosure where the reverse is true.

Volution Group

Volution Group has a July financial year end so it is only in October that we managed to scrutinise the company Annual Report for 2021. We are encouraged to find a change to the company's remuneration structure with ESG now firmly embedded in senior managements' Long Term Incentive Plan (LTIP). ESG KPI's now equate to 20% of 3 year LTIP where previously the focus was purely financial (75% EPS Growth and 25% TSR), Included in the package are a target for revenues from low carbon products and another for the percentage of recycled plastics in own products. Such a move is supportive for the investment case in that, not only are management focussed on issues which will bolster the environmental credentials of the company but are also likely to have a faster growing revenue line thanks to innovative environmentally friendly products and potentially lower costs as packaging usage becomes more efficient. We are particularly heartened by this news as we wrote to the company in February 2021 asking for ESG incorporation in the LTIP and have previously engaged with the company on this very matter.