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COP26:

an investor perspective

November 2021

For investment professionals only

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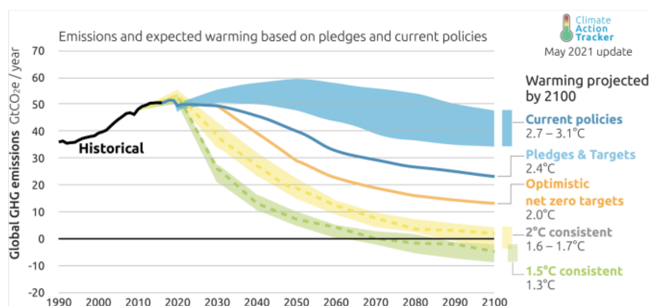
Early this month 197 nations of the UN Framework Convention on Climate Change will meet for the 26th time during the Conference of Parties (COP) in Glasgow. COP26 is very important, as it is the first conference, where the first 5 year progress cycle on implementation of the Paris agreements (COP21) to limit the global warming to 1.5 degrees Celsius by 2100 and to Net Zero by 2050 will be evaluated and updated.

Unfortunately, the sum of submitted up till now individual country national plans (NDCs) yield an alarmingly greater than 2 degree warming, let alone the 1.5˚C preferred scenario. In the meantime, climate changes is happening at much faster than the initially projected rate.

2100 Warming projections



Source: Climate Action Tracker, May 2021

Therefore, COP26 is all about the ambitions, affirmation of intentions and acceleration of regulations. The level of success of the conference will be measured by the level of aggregate commitments sovereign nations and businesses make on the key topics: acceleration of transition to electric vehicles (EV), renewable energy, phasing out of coal, reducing deforestation and mobilization of finance.

COP26 will be a good test on whether countries, especially outside the EU, are ready to put aside their perceived short term national interests and power games committing to faster de-carbonization, sharing of technology along with an increase in financial support.

WHAT HAPPENS IF COP26 FAILS:

- Climate change won't disappear itself. If COP26 fails, more urgent measures will have to be taken during COP31 (the next 5 years of the Paris agreements evaluation cycle). The transition will have to happen at an exponentially faster pace, leaving companies with less time to adapt and re-allocate necessary resources, avoid stranded assets or accept substantial re-pricing of assets. This will potentially result in overall higher inflation pressures going forward versus a gradual changes. If governments decide to act too late, the risk of an overshot in regulations will spike, (Inevitable policy response or IPR), which can also negatively impact economy and businesses.
- Most likely, in the short term, there will be profit taking in renewables, technology and industrials stocks, related to energy transition. At the same time, companies in traditional sectors like energy and materials will be safe for now, as they will not be hit by new regulations and high carbon pricing. The delay in transition will leave them with less time to adapt going forward, which most likely will be far more costly and disruptive.
- Failing COP26 and consequently lack of governmental actions in other regions will send the negative signal to delay transition plans to businesses, leading to an ever shrinking universe of adaptive companies for sustainable investing. At the same time, the level of investor activism and engagements on both national and business level is likely to surge.
- The EU, the US and a handful of other countries will likely try to compensate and reduce global warming on their own, through stricter regulations and higher taxes for companies operating on their territory. To comply, resident companies will have to either re-allocate their business to regions with no regulation or to increase investments, leading to cost inflation, lower profitability and decreased competitiveness. At the same time, local consumers will miss out on imports produced in less "green" regions or have to pay a substantial carbon boarder tax. All in all, the Gross Domestic Product (GDP) growth will slow down, leading to less availability of funding for energy transition.
- In the long run, it would also mean greater physical risks related to extreme weather conditions, melting of Arctic ice, health problems and increased competition for food and clean water sources. Companies exposed to the physical climate risks will be in a disadvantaged position and the overall level of profitability will most likely decrease. In a 2019 report, Moody's estimated the economic cost of climate change at $54-$69 trillion by 2100, even in a 1.5-2˚C scenario. Numbers will surge with every additional 0.5˚C warming. Other sources estimate a 10-25% negative GDP impact versus expected levels by 2100.

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WHY COP26 IS SET TO SUCCEED? WHY THIS TIME IS DIFFERENT FROM COP21 OR EVEN COP25?

It seems like this time will be different from COP21 or even COP25, as there are more supportive rather than opposing factors: back up from most of the biggest emitting nations/regions, including China and the US; there is a huge shift in public opinion and shareholder sentiment, ever increased awareness and commitments from businesses, which, in our view, are the key to success.

What has improved on national level?

Both the biggest emitters and the biggest investors in clean energy, China (28% of global emissions) and the US (15% of global emissions) are now on board with the climate transition. China is planning to reach neutrality by 2060, and the US by 2050. Interestingly, both countries seem willing to engage in strategic competition for climate leadership. China's support is crucially important for the energy transition, as it holds more than 90% of global rare earth metals and the main part of cobalt and lithium resources. Cumulative, 131 countries have committed to one or another type of Net Zero targets or has it in pipeline. However, not many formal action plans and legislations are in place. With a bit of luck, COP26 will increase the sense of urgency and stimulate the changes in national regulations.

What has changed on financial markets?

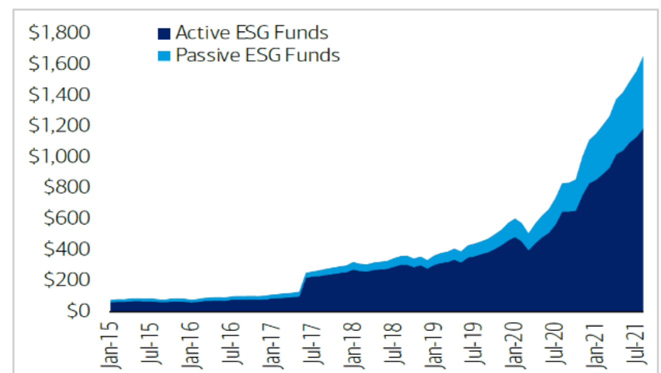
- There is a tectonic shift in the sentiment of the financial markets, which didn't react back in 2015 on the COP21 results. Over the last 5 years, ESG investing has become more mainstream with investors around the world looking at the risks associated with climate change as an integral part of the investment decisions they make. Interestingly, SRI and impact investing funds have also outperformed the broader markets since 2018 on cumulative basis. In 2021, almost 30% of all the equity fund flows relate to ESG, lifting the total asset under management in global ESG funds to 1.6 trillion, according to BOAML. This reflects an increased financial materiality in the investor community, which in return puts more pressure on politicians for a change.

Sustainability Market Indicators

Source: ACTIAM, MSCI, Bloomberg. Rebased -3Y=100.

- More investors excluding energy is putting pressure on the energy sector to change. An increasing number of pension funds and pension administrators around the world exclude not only coal-based activities and oil sands producers, but the Energy sector altogether. Think of the Norwegian oil fund, Swedish and Danish pension funds, as well as Pension funds PME, Horeca & Catering and ABP in the Netherlands.
- Financial markets are more and more organised in sending a clear signal to regulators, politicians and companies of the importance to manage physical and transition risk well. Think of initiatives aiming at carbon neutrality, like the Net Zero Asset manager initiative with $57.4 trillion AUM or Net Zero banking initiative with $39 trillion of combined assets.

Assets under management in global ESG Equity funds (US$ billions)



Source: EPFR Informa Financial Intelligence, BofA US Equity & Quant Strategy, 1/2015 – 8/2021

- A larger pool of adaptive companies allow more variability for sustainable investing, with topics like renewables or green building becoming relevant and investable themes. We define adaptive companies as companies in transition, with clear goals and progress on the way. They tend to have lower associated risks, higher growth rates due to exposure to the relevant markets and tend to enjoy valuation premium and lower cost of capital versus non-adaptive peers. Think of Kingspan, Rockwool and Saint Gobain basket for green building investment theme or ITM Power and Ceres Power for hydrogen. This broader base for ESG investors allows for more flexibility to react on e.g. new regulation.

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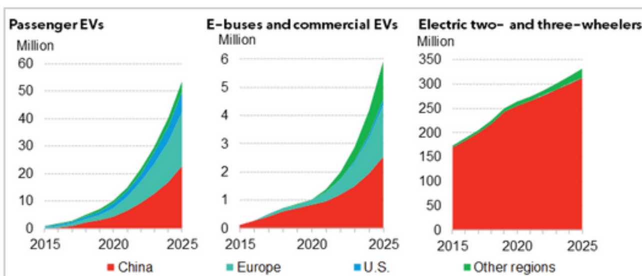
How has the business perception transformed?

- Mounting investor pressure has been changing the mindset of companies since 2018. BNEF's September report mentioned "Net Zero or equivalent commitment" of two thirds of the world biggest listed carbon emitters with a combined 80% of emissions. A further wave of announcements backed by COP26 excitement came in October 2021 with through international coalitions and association committing to Net Zero even in such hard to abate emissions sectors like Cement, Aviation, Shipping and Metal & Mining. So far, circa two thirds of companies in the S&P 500 and close to 80% of companies in the STOXX 600 have some form of decarbonisation targets.
- Companies are increasingly looking for ways how to incorporate climate change in their accounts. S&P Global and Danone are introducing carbon adjusted earnings per share metric into financial reporting, which adjusts the regular earnings per share by a theoretical emitted CO_2 price per share. As the absolute number of emitted tonnes decreases, adjusted earnings increase faster than the real earnings. The metrics improve transparency and provides investors with more granularity on future cash flows and valuations. Hopefully, this methodology will become an industry norm going forward.
- Maturing of a number of crucial clean technologies over the last six years, leading to a substantial drop in costs and an increase in competitiveness versus high-carbon alternatives. Leading in itself to changing dynamics in several sectors. We will outline the key changes happening for Road transportation, Energy and Utilities since 2015, as the most relevant for the COP26 goals. Future cash flow generation and returns are left intentionally out of the scope of the article.

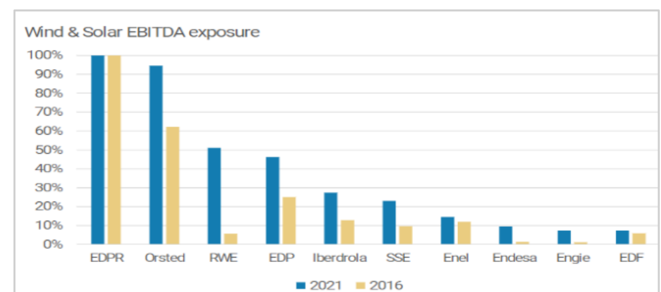
Global EV fleet by segment and market



Note: Two-wheelers includes mopeds, scooters and motorcycles, excludes e-bikes. Source: BNEF.

- **Battery electric vehicles:** enjoyed a rapid increase in adoption rates, especially in 2021, from almost non-existent level back in 2015. In parallel, pure EV companies saw a spectacular growth in share prices and market caps. The auto industry as a whole is however still not aligned with Net Zero, BNEF only expects a 16% penetration of the global fleet by 2025. Nevertheless, the future becomes brighter due to 1) expected stricter regulations; 2) strong commitments from automakers around the globe to transform business models through EV investments and sales targets (40-100% of new car sales are targeted to come from EVs by 2030); and 3) rapidly dropping battery storage costs, which will make EVs more affordable to end consumers. We hope that a positive COP 26 will stimulate a smooth transition of this sector through a policy response to invest into grid infrastructure and battery recycling, which remain key bottlenecks so far. A COP26 that is not ambitious enough could delay transition with the risk of more future disruption and stranded assets.

EBITDA exposure to Renewables



Source: Company Data, Morgan Stanley Research

- **Energy** (including Scope 3 related emissions in heating, transportation and industry) and **Utilities** are the most carbon intensive sectors. In Europe, both sectors are going through drastic transformation and business model adjustments, repositioning into renewable energy sources. Maturing solar and wind technologies led to a respective 82% and 45% drop in the cost of production in $/Kwh over the last six years, according to RethinkX, with a further 30-70% decline projected over the next ten years. Increased competitiveness of technologies, combined with tougher regulations and changed sentiment of the financial market, accelerated the transition. European Utilities started transition earlier, which can be clearly seen through changes in the income level generated from wind and solar between 2016 and now.

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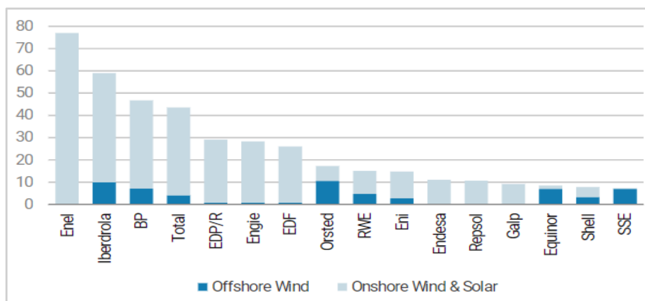
A 310% or 270GW growth in renewable capacity is targeted by 2030 (up from the current 87GW) and a large part of expansion plans is already secured, making the transition process irreversible. The progress for the European Energy sector is much slower and started only in 2019, with renewable capex staying way under 10% in 2021. So it is all about ambitions of increasing solar and wind capacity from 10GW today to 151GW, 140% growth, by 2030. Acceleration of transition to renewables and phasing out of coal plants will be among the hottest topics of COP26. Both sectors depend on national governments for auctions and approvals and stricter national commitments to decarbonization after COP26 could increase the number of auctions and speed of approvals.

Company targets implied net renewables growth to 2030 capacity (GW)



Source: Company Data, Morgan Stanley Research

- Some companies, like EDPR and Orsted, have already emerged as pure green players with 100% of their installed capacity and production being emission free. These are success stories on both sustainable and share performance levels that can provide incentive to other companies. Other companies, like Volkswagen and SSAB are the emerging ESG leaders in the dirty sectors, starting to enjoy momentum. Further investor stewardship can facilitate the transition.

INVESTMENT VIEW FOR COP26 SUCCESS

- COP26 would be a catalyst to pressure more companies to adopt Net Zero targets. Because of the increased materiality the market will react and differentiate. Therefore, polarization between the ESG winners and loser will continue with further misalignment of valuation multiples in every sector and/or region.

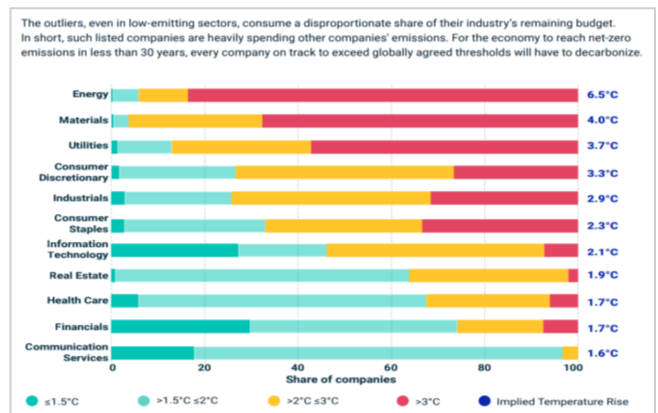
  The key beneficiates will be companies that have already started their transition, many of which are in the developed countries, and companies that are exposed energy transition supply chain (EV's, renewables, etc). The carbon neutrality targets are likely to be scrutinized by the investors for the action plans and milestones.

The lack of the targets would label a company as non-adaptive, implying higher long term risks and competitive disadvantage. The company will have to start adapting its business model eventually, in order to not lose access to financial markets, but the change will be more rapid and costly.

The laggers are likely to be divided into two categories. The first one will include companies that just lack action in sectors with destablished technology for energy transition and a decent cost economics. A good example is RWE, which is very slow in phasing out of coal-related activities, or Ford which lags peers in targets for EVs sales by 2030. As you can see from the chart below, there are plenty of companies in even low-carbon sectors that are lagging behind. (marked red and yellow). These companies will be either excluded or engaged with.

Another group relate to companies in carbon intensive sectors, where technology doesn't exist or has limitations or is not yet cost effective, which challenges transition. Think of aviation with still uneconomical sustainable fuel and electric planes in start-up phase. Cement is another industry, where zero-carbon technology of CeraTech can't be used for most of applications.

Implied temperature rise by GICS® sector



Source: GICS®

- Acceleration of existing trends in energy transition will create investment opportunity of up to $1.1 trillion by 2030 in the US per IFC and close to $250 billion by 2025 in Asia according to PWC. BAOML estimates that the green transition can add 0.3%-0.5% of global GDP growth per annum in the long-term.

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- Carbon pricing: was not material enough to impact earnings up till now, despite tripling in price over the last 3 years. Just to put things in perspective, the International Energy Agency (IEA) estimates that the average global carbon price in excess of $200/tonne is needed to meet Net Zero. IMF has $75/tonne estimate, which is still times above the current $3/tonne level (keep in mind that the number is very low, as only 20% of global emission covered by actual carbon pricing schemes). Companies operating within the Energy, Power, Materials and Transportation sectors will be the most impacted by hiking carbon prices. Adoption of carbon-adjusted earnings methodology for these sectors could really help increase the transparency and track improvements.
- In the short term, positive sentiment from COP26 is likely to revive excitement around ESG as an investment theme, which has been consolidating this year due to the value rotation and the energy crisis. In the longer term, the accelerated transition will lead to an increase in the universe of adaptive companies for sustainable investing and the number of investable themes. A broader investable universe in combination with higher regulatory pressures around the globe and a further shift in investment sentiment is likely to accelerate ESG related flows to financial markets.

CONCLUSION

COP26 is all about the ambitions and acceleration of regulations with the level of success being measured by the level of aggregate commitments sovereign nations and businesses make on the key topics like renewables, EVs, deforestation and mobilization of finance. We feel the changes that happened over the last 5 years, including support of China and the US, a huge shift in public opinion and investor sentiment, as well as an increased of awareness and commitments from businesses and the financial industry, increase the probability of success.

If COP indeed succeeds, the synchronized global response will allow moderate pace of transition, resulting more economic stability, lower levels of inflation and lower physical risk. If COP26 fails, the delayed transition will be more rapid, with risk of governmental polices overshoot, higher inflation and lower economic growth.

Key points from the investor perspective (asset owners in this case) in light of successful COP26 are:

1. Further polarization between the ESG winners and losers will continue with further misalignment of valuation multiples in every sector and/or region, as the financial materiality will increase. The winners will remain companies that are already in transition and/or are exposed to climate solutions, while laggers will companies in carbon-intensive sectors and/or companies without targets or detailed action plans for transition. Laggers will eventually will be forced to start transition in order to avoid being cut off from the capital markets, but at a higher cost.
2. While the net zero targets will become licence to operate, investors will scrutinize the existing transition plans, allocated resources and capex to avoid greenwashing.
3. Non-adaptive companies will come under pressure from carbon pricing in mid-term.
4. In the short term COP26 positive news flow can revive performance of sustainability as an investment theme, which has been consolidating this year due to value rotation and the current energy crisis in Europe.

If the COP fails, the impacts will be opposite to a large extent. High carbon intensive sectors will be safe for now, triggering a potential relief rally and profit taking for sectors related to climate solutions supply chain. The transition itself will however become more rapid and disruptive as the risk of stranded assets for high carbon intensive sectors will increase, with risks shifting to the future. ESG winners will see some profit taking due to a delay in supportive legislation and lower expected mid-term growth. Globally, it will not be a level playing field, as regions continuing with the energy transition (most likely the EU and the US) will tighten regulations for resident companies reducing their competitiveness or forcing them to re-locate. This, combined with the increased physical risks will tamper the GDP growth and increase economic instability, leading potentially to a social unrest.

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ACTIAM Sustainable European Equities

This strategy is being managed by ACTIAM's Equity team, consisting of 9 professionals with an average experience of 21 years in the industry. The team also manages our index and impact equity products. The team manages a total assets under management of more than €13 billion, of which €2.7 billion in this active strategy.

Investment philosophy

- Companies with a strong sustainable profile are tomorrow's winners. Strong ESG profiles translate to lower risks, lower costs of capital and higher valuations.
- Adaptive companies with a distinct advantage (moat) can protect their market share and profitability better.
- Stewardship concept helps steer companies towards more sustainable behaviour.
- Behavioural biases create investment opportunities for long term investors.

The ESG integration process weighs our focus towards a long term investment horizon and facilitates active selection process.

Read more on our equity funds or go directly to the fund page of ACTIAM Sustainable European Equities

ACTIAM manages assets of appr. €22 billion (ultimo September 2021). Our solid (impact) strategies and sound performance track record will help you to achieve your goals. We offer sustainable solutions to insurance companies, pension funds, banks and distribution partners. This is achieved through actively and passively managed investment funds and mandates.

Read more about ACTIAM on our website.

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