WALTER SCOTT

BNY MELLON | INVESTMENT MANAGEMENT

*Quarterly Report*

# RESPONSIBLE INVESTMENT COMMENTARY

*Quarter ending 31 December 2021*

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# QUARTERLY COMMENTARY

*Quarter Ending 31 December 2021*

## COMMENTARY

The eyes of the world were on Glasgow in November, as the city played host to the COP26 climate conference. With 120 heads of state in attendance, hopes were high that the conference would build on the 2015 Paris Agreement and mark another important step on the journey to a carbon-neutral economy.

But while the media's gaze may have been fixed on the great and the good, behind the scenes thousands of delegates discussed the real-world practicalities of climate change and the detail of how best to decarbonise the global economy. The significance of these issues for investors is huge; climate and carbon are themes set to define the investment landscape for generations to come.

With these conversations taking place practically on our doorstep (only some 45 miles door-to-door from our Charlotte Square offices), CEO Jane Henderson and Head of Responsible Investing Alan Edington made the short trip to hear first-hand how these issues might evolve and the potential implications for our clients' assets.

*"Climate and carbon are themes set to define the investment landscape for generations to come"*

Over the course of a day, a range of companies and business organisations shared their thoughts on how best to fund and manage the energy transition. Infrastructure investors and renewable energy providers, tech giants and innovative start-ups, the sheer diversity of the views on offer makes a succinct summary of the day difficult. It's clear that many companies are firmly on the front foot on climate and are working hard to decouple their growth from carbon emissions.

There were fascinating insights into some of the emerging technologies that will help accelerate decarbonisation, from modular home building (effectively building a house in a series of modules on a factory production line), an energy efficient process that uses less materials and generates less waste, to analysis of eating habits that helps local farmers grow the right crops in the right volumes. With innovation comes opportunity and keeping abreast of these trends will be vital for investors.

Perhaps most striking, however, was the real sense of a fundamental shift in the attitude of business towards climate issues. Until recently, climate was very much viewed as a reputational matter and a risk to be managed. Today, it's being embraced as necessity and more importantly as an opportunity. This change in mindset is both welcome and encouraging.

Whether or not the Glasgow Climate Pact agreed at COP26 goes far enough in tackling climate change is now the subject of some debate. From our perspective, progress on major issues, such as methane emissions, deforestation and coal, was an undoubted positive, as was the presence of China at the negotiating table. But there was a failure to lay out concrete plans for how to get the required funding to where it needs to be, in effect the establishment of a mechanism for fulfilling the goals set out in Paris in 2015. Although many businesses are taking their own, very welcome, steps towards reducing their impact on the climate, it is for governments to set and enforce the parameters of the transition. A lack of a clear, achievable, and binding agreement was a missed opportunity.

This growing commitment of companies to climate issues was very much in evidence in our conversations with management teams during the quarter. The assessment of material risks and opportunities is increasingly integral to, rather than an appendage of, long-term business strategies.

*"A lack of a clear, achievable, and binding agreement [at COP26] was a missed opportunity"*

Fresh from catering for COP26, **Compass Group** spoke to us about the rising tide of sustainability expectations from its customers. "Growing everywhere" was how the new CFO put it, although the pace of growth differs by location. In the UK, for example, some 70% of new business opportunities now cite sustainability as a top priority, and for some customers, it is now rated more important than cost.

Compass itself unveiled ambitious new climate targets in October, committing to net zero in its own operations by 2030, and across its value chain by 2050. Acknowledging the contribution the international food industry can make towards decarbonisation, the company will work with clients, industry associates, governments and suppliers to "help create a more sustainable global food system". Given the scale and global reach of Compass and its supply chain this has the potential to be a significant development. Initiatives include greater use of renewable energy, electric vehicles, plant-based protein alternatives, regenerative agriculture, and locally sourced produce. As the first international contract caterer to announce a 2050 net zero commitment, we agree with management that the announcement further bolsters the company's sustainability credentials and enables Compass to position itself as a partner for customers looking to meet their own climate commitments.

While acknowledging that not every company will be as far along their climate journey as Compass, as responsible investors we do expect management teams to display an understanding and strategy in relation to material climate risks and opportunities. In that regard, **The Coca-Cola Company** has work to do to improve its sustainability credentials, but it is positive that management is now taking direct steps to address some of its most significant challenges, having recently set meaningful, and in some cases stretching, targets on packaging and emissions. A commitment to collect one piece of packaging for every piece it produces by 2030 will not be easy to achieve, but an increased collection rate is critical if it is to hit its target of 50% recycled material across all packaging by the same year. Given the size of its business, Coca-Cola has a big impact in a global context, so its success would mean the world will have made significant inroads into solving its plastic problem.

On emissions, Coca-Cola is targeting a 25% reduction in direct emissions by 2030. It is also considering how best to address emissions across it supply chain, which account for some 85% of the overall total. The intention is to finalise a plan before setting any targets, rather than plucking a figure out of the air and hoping for the best. Provided the plan includes material and challenging targets that demonstrate the business is approaching these issues with sufficient urgency, then we believe this to be a sensible course of action.

Any plan to materially cut Coca-Cola's indirect emissions will require close coordination throughout the company's supply complex. Encouragingly, several of its partners are already embracing this challenge; some large bottling partners have net-zero goals in place, while others have set science-based climate targets. All this marks undoubted progress for Coca-Cola but we're aware there is still more it can do to reduce its overall impact. Should it drag its heels, the business will risk a consumer backlash. We will continue to monitor future developments and engage with management when necessary, using our influence as long-term shareholders to encourage and support the company as it progresses to a more sustainable operating model.

*"Coca-Cola is targeting a 25% reduction in direct emissions by 2030"*

In our view, considered engagement remains the most effective tool available for advocating for positive change at a company. It's not always successful, and it's certainly not always quick, yet a patient and proportionate approach underpinned by respectful but frank dialogue is more likely to yield results than the use of some blunter instruments. A case in point is **CLP Holdings**, the Hong Kong-based utilities business. Since 2019, we have engaged with CLP on its carbon emissions, proposing that the company undertake a faster disposal or decommissioning of its coal-fired assets.

As a business, CLP has always been open to constructive engagement. It has also been something of a leader in its commitment to decarbonisation, having issued its inaugural environmental plan in 2007. Refined and strengthened several times since then, this strategy is an excellent example of its kind, making use of science-based targets, with a detailed roadmap of investments and closure timetables for specific assets based on currently available, rather than unproven, technologies and costs. However, it was our belief that CLP could do more to tackle the significant contribution of coal to its overall emissions.

We therefore welcomed the announcement of the latest iteration of CLP's decarbonisation strategy. As well as committing to achieving net-zero emissions across its value chain by 2050, the company will now phase out coal-based assets by 2040 – a decade earlier than previously pledged. Why not faster? These are complex actions. Where it has coal assets, CLP is often a major employer with plant closures having a potentially devastating impact on local communities. Closure is also contingent on available, alternative power. Not long after the company unveiled its updated targets, we spoke with management, congratulating them on their ambition, and discussing some of the future opportunities that will flow from being a key facilitator of the energy transition in Asia Pacific.

*"The best companies now understand it is "impossible" to deliver long-term growth without consideration of material sustainability issues"*

Speaking with CLP's CEO, it's clear that the company's mission to decarbonise is not a resigned response to regulatory pressures but reflects rather a purpose-driven internal culture centred on the creation of a genuinely sustainable business model. The merits of this approach were championed at our virtual investment conference [LINK] in November by Paul Polman, former CEO of **Unilever** and now the Chair of Imagine, a for-benefit foundation that mobilises business leaders around the issues of climate change and global inequality.

As CEO of Unilever, Mr Polman was a pioneer, putting sustainability at the heart of the consumer goods giant's business model long before these concerns were commonplace. Today, his approach is gaining traction, and he noted that the best companies now understand it is "impossible" to deliver long-term growth without consideration of material sustainability issues. Unfortunately, argued Mr Polman, not all companies have the requisite skills and knowledge at board level to embrace this reality.

Increasingly, this is also understood by investors, and there is mounting evidence to suggest that asset owners now acknowledge that robust sustainability practices have a

positive impact on shareholder value. Gone are the days when such an approach was thought to erode value. What were once viewed as non-material factors are now recognised as central to the delivery of sustainable long-term shareholder value. Those companies that fail to understand this and act accordingly are unlikely to deliver the long-term wealth generation that long-term investors should demand.

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