Oldfield Partners

More than meets the eye on climate change

Our contrarian, value-driven investment philosophy is centred on owning essentially sound businesses at unusually low valuations, both in absolute terms and relative to their own histories. We are focussed on companies or industries that are out of favour – we believe there is real opportunity to look closely at those companies where most other investors have taken flight. The reasons for negative investor perception towards a stock vary widely but will often encompass concerns over poor environmental, social or governance (ESG) issues.

We have always considered it an important part of company analysis to assess corporate governance, as well as the management of social and environmental issues. This forms part of our risk assessment of business fundamentals. Ignoring ESG considerations may lead to an incomplete understanding of the risks to an investment case and may result in the wrong investment decisions. Successful integration of ESG factors can contribute positively to the risk-adjusted returns achieved by the investments we make on our clients' behalf.

Our starting point is not to exclude any particular sectors or countries unless excluded in individual managed accounts by the client concerned. We do avoid companies about which we have serious governance concerns, and companies in which we have reservations about business being conducted in an unethical manner, unless it is clear that such concerns have been or are being dealt with by management and any shortcomings have been addressed. We have found ESG-related issues can provide us with investment opportunities where improvement plays a role in the recovery of results and perceptions of a company and its share price.

There are elements of a broader sustainable investment approach that we do not incorporate. For example, our value-driven, index-agnostic approach makes it incompatible with "impact" investment where investors actively seek a social or environmental return separate from, or in addition to, a financial return.

One ESG issue in particular dominates the news headlines these days and that is climate change. While we have historically had to assess environmental issues and controversies among the companies in which we have invested, we have not until now, adopted a systematic appraisal of the climate-related issues at these companies. This will change in 2020 with the incorporation of analysis of the greenhouse gas emissions and associated company policy on combating climate change together with an assessment of the threats to the company of climate change. We are committed to playing our part in lowering harmful emissions by engaging with the companies in which we invest to reduce their greenhouse gas emissions.

We are now signatories of Climate Action 100+, an investor initiative of more than 370 investors with more than USD $35 trillion in assets under management. Climate Action 100+ is coordinated by five partner organisations across the world including the Institutional Investors Group on Climate Change (IIGCC) in Europe and the United

Nations-backed Principles for Responsible Investment (PRI). We are signatories to the PRI with an 'A' rating and members of IIGCC. IIGCC has more than 170 members, mainly pension funds and asset managers, across 13 countries, with over €23 trillion in assets under management. Finally, OP is a Tier 1 respondent to the UK Stewardship Code.

Climate Action 100+ was established to focus on the world's largest corporate greenhouse gas emitters, ensuring that they take the necessary action on climate change. The companies include 100 'systemically important emitters', accounting for two-thirds of annual global industrial emissions. In addition, members have nominated 61 other large emitters with significant scope to lower their emissions and contribute positively to reducing climate change.

Climate Action 100+ signatories seek action from boards and senior management of companies to:

1. Implement a strong governance framework around climate change risks and opportunities.
2. Take action to reduce greenhouse gas emissions across the value chain in a manner consistent with the Paris Agreement.
3. Provide enhanced corporate disclosure in line with the recommendations of the Task Force on Climate-related Financial Disclosure (TCFD).

The key point of joining Climate Action 100+ is to enhance our engagement with the power of collective engagement. While it would be great if all the companies with which we engaged on our own acted immediately on our points, we recognise that this is unrealistic. This doesn't stop us doing what we think is right, but we know that companies are more likely to alter their course if they hear the same thing from lots of shareholders individually or through a collective engagement. The more investors like us who can add their support to these important issues, the better.

Our own engagement policy is multi-layered and begins with conversations and correspondence with corporate investor relations teams. Without a satisfactory response we escalate to senior management (ideally including a face-to-face meeting). Where we find management unreceptive, we escalate to the board through the chairperson or the lead-independent director. If we feel an issue is critical to unlocking or protecting long-term value, or on climate change-related action, and we have seen an insufficient response from management and the board we will vote against those members of the board standing in the way of change. We will do this after informing the company concerned. We are not proponents of divestment unless we believe the lack of board and management action prevents the unlocking of value and efforts to unseat them are blocked by entrenched shareholders that are unlikely to be removed within our investment time horizon.

We highlight some examples among the companies in which OP currently invests that are tackling their emissions. Four of these companies appear in Climateaction100's list of the world's top 100 carbon emitters. Far from being climate change 'no hopers', on closer inspection, they have meaningful positive trends that we think are often overlooked.

1) **The Oil Major – Eni**

This Italian oil & gas company has embarked on a renewable investment phase targeting €1.4bn a year in capex over the next four years (against €6.5bn a year in oil & gas exploration and production) to reach an installed base of 1.6 gigawatts (GW) of renewable capacity by 2022 (mostly solar) and more than 10GW by 2030. This forms one part of Eni's commitment to play its part in the Paris climate agreement goals of reducing the 32 gigatons of CO2 emitted by the global energy sector in 2017 by 45% by 2040 whilst delivering on the 30% increase in energy demand expected globally by 2040. Eni are targeting zero net emissions on a direct basis for their upstream business by 2030 through a combination of increased use of technology to boost efficiency; investing in offsetting forestry; growing their share of gas over oil (to 60% vs 40%); using more renewable electricity in their mix and investing in carbon capture and storage, targeting more than 20m tonnes a year of captured CO2 by 2030. Eni has more work to do on emissions in its downstream business to fully align the company with the Paris agreement pledges.

2) **The Utility – Korea Electric Power**

While KEPCO's carbon intensity is only just lower than the global utility average, it's nuclear fleet provides it with a structural advantage should the Government, a 51% controlling shareholder, change tack on its anti-nuclear stance. The current Government has been both anti-nuclear and anti-coal since it came to power in 2017. This has been a problem for KEPCO which is dominated by its nuclear and thermal power stations that together provide 92% of its generating capacity. However, KEPCO does have renewable capacity which represents 8% of its generating capacity, and one third of Korea's total renewable energy capacity. Renewables in Korea represent 15% of total electricity generating capacity. The Korean government's existing target is for an increase in renewables to 37% of all capacity (to meet 20% of demand) by 2030. Earlier this year, the government released a draft of its third basic energy plan mooting a goal of over 100GW of solar and wind power by 2040 that would supply 30-35% of all power demand in South Korea. The government has yet to decide how it will split this between KEPCO and the independent power sector but KEPCO currently represents 68% of the country's generation capacity and is therefore likely to play a major role.

3) **The Auto Manufacturer – Toyota**

In 2015, Toyota announced its Environmental Challenge 2050, seeking to reduce the environmental burden of cars to zero by 2050. The goal is, as far as possible, to reduce

CO2 emissions generated during driving to zero, to reduce CO2 emissions generated throughout the lifecycle of a car—from production to disposal—to zero, and to reduce CO2 emissions generated by the plants that produce the cars to zero. Today, Toyota is the second largest global auto manufacturer with annual output of almost 10 million vehicles. It is also the world's largest producer of hybrid powered vehicles with an estimated 40% market share in 2019. Hybrid sales account for c.5% of global auto sales today, double the level of battery-electric vehicles. At a fleet level, hybrids produce about 40% less CO2 per mile than regular petrol cars. While not, on their own a solution to zero emissions goal, they form an important stepping stone. Toyota continues to develop their own battery-electric vehicles with a special and leading R&D focus on solid state batteries that offer the potential for much denser batteries with greater capacity and significantly faster charging times. Toyota is partnering with Panasonic on this research and on scaling lithium-ion batteries with a goal of building 5.5m battery-powered vehicles by 2025. The company's emissions intensity and target are aligned with the Paris agreement.

4) **The Industrial Conglomerate – Mitsubishi Heavy Industries**

MHI is developing a hydrogen-fuelled gas turbine. In the first instance, they will fire turbines with LNG and a 30% hydrogen mixture. This would reduce CO2 emissions by 10% vs conventional gas-fired plants. Later iterations are planned to be 100% hydrogen powered. MHI's latest gas turbines have 64% efficiency, halving the CO2 production compared to conventional coal-fired power generation. MHI also have a 50:50 JV with Vestas in offshore wind turbines where they are #2 in that market.

5) **The Semiconductor Manufacturer – Samsung Electronics**

In June 2018 the company stated that it would switch to using 100% renewable energy at its facilities in the UK, Europe, China and the US. It is also investing in renewable capacity in South Korea where 65% of its global energy consumption is derived. It will have installed 63,000 sq. metres of solar panels at two facilities in Korea by 2020 when it estimates it will be using renewable energy globally equivalent to a 3.1GW solar plant.

6) The Miner – Rio Tinto

Last year, Rio Tinto established a JV with Alcan called Elysis which has developed a zero-emission production process for aluminium by replacing the traditional carbon-

derived anodes with a proprietary anode material that means the only gas produced being oxygen. With a greater focus on carbon emissions generated by a firm's supply chain, this will push producers and manufacturers worldwide to focus on decarbonizing their supply chain and processes raising demand for the Elysis technology. Rio and Alcan expect the technology to be commercially available to all aluminium producers by 2024 and say that the technology can be retrofitted to existing smelters. They claim that if the Elysis technology is adopted in Canada alone, it has the potential to reduce the annual greenhouse gas emissions by approximately 7 million metric tons, which is the equivalent of removing 1.8 million cars from the road. Clearly, if a smelter used only renewable energy then the entire aluminium production process would be zero-emission. Aluminium production globally accounts for c.1% of global carbon emissions. On December 5th, 2019, Apple announced a world first, its first purchase of carbon-free aluminium from Elysis.

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The value of all investments and the income from them can go down as well as up; this may be due, in part, to exchange rate fluctuations. Past performance is not necessarily a guide to future performance.