The Old Continent Is Now the New World

How an ESG revolution is transforming European investment opportunities.

June 2022

KEY INSIGHTS

- Regulatory and societal pressures have ignited an environmental, social, and governance (ESG) revolution for companies and investors in Europe.
- ESG matters because it gives forward-thinking companies that have adapted their businesses over many years a competitive advantage.
- ESG is integrated at every stage of our Responsible European Select Equity Fund's investment process, and we have built a portfolio with a strong ESG profile.

Tobias Mueller
Portfolio manager, T. Rowe Price European Strategies

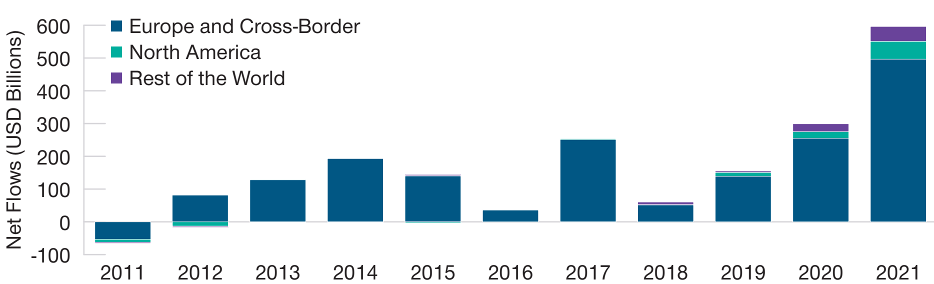
Three forces have put Europe in the vanguard of environmental, social, and governance (ESG) innovation: Long-standing investor interest in ESG opportunities, an advanced regulatory regime, and growing consumer and societal demand for socially responsible investments.

Investor Demand Around ESG Has Propelled Asset Growth

European investors have been the primary investors in ESG funds for more than a decade. In the past three years, virtually all net investment flows in the region have been into ESG-labeled funds. These assets now exceed

Europe Has Long Been an ESG Global Leader, Driven by Investors

(Fig. 1) ESG net flows (USD billions)*



As of December 31, 2021.
*Blue portion of column shows net flows into ESG funds in Europe and cross-border investments, primarily Luxembourg—or Dublin-registered vehicles, mainly used by European investors, with some Asia Pacific and Latin America utilization.
Source: Broadridge Global Market Intelligence data. Excludes money market funds and funds of funds. Does not include institutional mandates or private funds.

> Making Europe the first climate-neutral continent is our goal.
>
> **— "Fit for 55" policy document, European Union, July 2021**

USD 4 trillion (see Fig. 1), or more than a third of total funds invested.

This is partly because major institutions and smaller investors in the Nordics and countries such as France and the Netherlands embraced ESG considerations in asset allocation decisions more quickly and with greater enthusiasm than other regions.

Regulation a Key Driver of ESG Opportunities

The second big force has been regulation, which has been a pivotal driver of ESG principles and practices. Europe is a superpower in this area. Previous efforts were more piecemeal and were reliant on national governments. In the last couple of years, the European Union (EU) has become more influential, intentionally using regulation to redirect capital flows and accelerate a transition to a carbon-neutral, green, competitive, and socially inclusive economy.

A recent example of this legal effort is the Sustainable Finance Disclosure Regulation (or SFDR as commonly used). This sets very significant disclosure requirements for asset managers, who will have to report environmental and social data on their aggregated assets, including an assessment of annual improvements.

The European Commission's (EC) aim is to create a carbon-neutral continent by 2050, recently adopting measures that represent a more comprehensive policy response than those typically seen in the past.

To help finance the transition and support an economic recovery from the coronavirus crisis, the EC launched the "Fit for 55" agenda, which came into law this year, targeting a 55% cut in emissions by 2030 compared with 1990 levels. It also set aside EUR 800 billion under its "NextGenerationEU" budget.

It updated these plans in the REPowerEU program launched in May, which aims to end the EU's dependence on Russian fossil fuels and accelerate the rollout of renewable energy to replace fossil fuels in homes, industry and power generation.[1]

Society Demands Change

The last force is society. People are demanding radical change and embracing the adoption of more sustainable economic practices and goals to prevent catastrophic, lasting damage to the planet and its climate from human activity. Admittedly, this is true not only in Europe but elsewhere. For many consumer-facing companies, it is no longer credible to have a sustainability strategy and not to be vocal around issues relating to the environment, equitable treatment and macropolitical concerns.

This trend is clear in Europe's largest economy, Germany, which is now led by a coalition government that includes the Green Party. The party effectively secured all of its main demands in the negotiations to build the coalition, which has never been done before in the country. Demands for the adoption of more sustainable economic goals are consequently now being reflected in a range of government policies.

Companies Have to Evolve

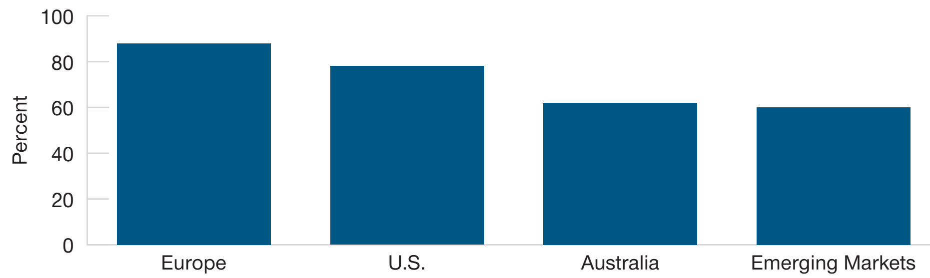
European corporates have not been immune to these pressures for change—they have had to evolve as countries began legislating for greener businesses, economies and societies.

While businesses have usually associated regulation with something negative, we would say that in the case of ESG the opposite is true: Regulation has been a positive factor for European companies.

[1] Source: European Commission: REPowerEU: A plan to rapidly reduce dependence on Russian fossil fuels and fast-forward the green transition.

Europe's Companies Have the Most Attractive ESG Profile

(Fig. 2) European corporates have established global leadership in adopting ESG criteria into their operations



As of December 31, 2021.
Source: T. Rowe Price Responsible Investing Indicator Model. Data compare scores for companies within MSCI All Countries World Index. Data are RIIM data for leading benchmarks: MSCI Europe, S&P 500, ASX 200 and MSCI Emerging Markets, respectively (see Additional Disclosures).

Siemens: Transformation Into a Digital Giant

Siemens, one of Europe's largest industrial companies, with a market cap of USD 150 billion, is a notable example of how companies have changed. The process for Siemens had already begun by 2003, when the company was one of the early signatories of the United Nations Global Compact, a nonbinding pact to encourage companies to adopt sustainable and socially responsible policies. In 2015, it was one of the first industrial companies to commit to net zero for its own operations by 2030.[2]

Siemens has morphed from an old-fashioned manufacturer and supplier of equipment, with a heavy reliance on dirty industries and processes, into the world's No. 1 automation and industrial software company. We calculate that it now generates over 60% of its revenue from sustainable sources.

As a result of these forces, European companies are now the leaders in adopting ESG criteria into their operations. We see this displayed in hard data as well.

ESG Risks and Opportunities

We use a proprietary Responsible Investing Indicator Model (RIIM) to assess the ESG profile and performance of more than 15,000 companies around the world. The model uses over 200 data points from a range of providers and spans 22 categories.

Within RIIM, European companies score better than peers in other regions across all 11 MSCI sectors.[3] Europe also outscores the rest of the world on each of the three ESG pillars. And when leading equity benchmarks are compared, Europe also has a higher percentage of companies achieving our best rating—green—than the U.S., Australia and emerging markets.

Identifying an ESG Edge

Symrise, a German ingredients business, is an example of a company that has established a long-lasting competitive advantage by setting up sustainable and secure supply chains, so called backward integration.

[2] Net zero means achieving a balance between the greenhouse gases put into the atmosphere and those taken out. This state is also referred to as carbon neutral.
[3] Source: T. Rowe Price Responsible Investing Indicator Model, data as December 31, 2021.

The specific securities identified and described are for informational purposes only and do not represent recommendations.

> ...ESG leaders are often leaders in more than one area...they are usually led by forward-thinking management teams.

Many companies have moved to improve the security of their supply chains since the coronavirus pandemic and because of trade wars. Symrise, however, started the process of backward integration long before it was considered important, when factors such as extreme weather and sociopolitical unrest in some of the regions where it operates affected the price and availability of natural raw ingredients. It found that being closer to suppliers and helping them succeed in their affairs ensured a more sustainable business.

For example, vanilla is a key ingredient in some of the essences and flavors that Symrise makes, and 80% is produced in one area of Madagascar. Symrise has had its own operations there since 2006, working directly with local farmers and communities and subsidizing education and health care. Consequently, after a cyclone ravaged vanilla tree plantations in 2017 and pushed up prices, Symrise was one of the very few companies in the industry that still had access to this key ingredient.

We find that companies that are ESG leaders are often leaders in more than one area, and that is because they are usually led by forward-thinking management teams. A case in point: Symrise was not only forward-thinking in ensuring the backward integration of its supply chain but also in spotting a new opportunity presented by being innovative in pet food ahead of the market. So it started diversifying into that area, which is now one of its growth engines.

Ashtead: Rental Penetration

Ashtead, an equipment rental company, is another company that illustrates why ESG matters. The rise of ESG concerns has led companies in many industries to think of ways to reduce their emissions of carbon dioxide. Renting rather than buying agricultural, cleaning and construction equipment is an effective way to do that. Ashtead also performs predictive maintenance and repair of tools before they break, thereby improving the utilization of assets and extending their lifetimes.

In the case of Ashtead, ESG matters because it has prompted the company to increase its addressable market and to go beyond traditional infrastructure and construction activities.

Rockwool: Growth Opportunities

In addition, there are companies and industries that will benefit from the EU's "Green Deal," which aims to make the bloc's building stock much more energy efficient. Currently, buildings account for about 36% of greenhouse gas emissions and 40% of energy consumption in the EU, and about 75% of them are not energy-efficient.

We think Rockwool International, a Danish insulation materials company, is a likely beneficiary of this wave of development. The company earns about 50% of its revenue from building renovation, with about 70% generated in Europe. Rockwool, which historically has grown about 5% per year over 20 years, is well positioned to add several hundred basis points of annualized topline growth in the years ahead.

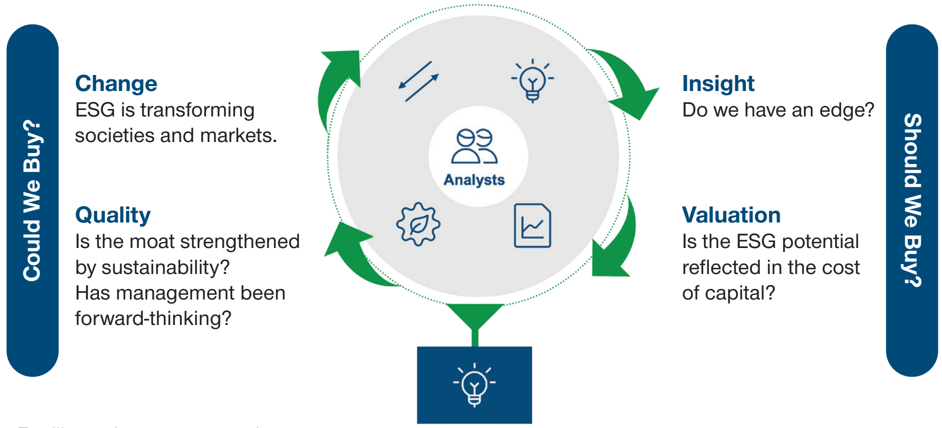
ESG Embedded Across Investment Process

Our investment-driven engagement program frequently identifies targets through our proprietary RIIM analysis, governance screening, and the fundamental research of our global analyst platform. We base our investment process on four pillars:

- Quality
- Change
- Insight
- Valuation

Identify Best Ideas

(Fig. 3) ESG considerations are embedded at all stages of investment process



For illustrative purposes only.
Source: T. Rowe Price.

We start with an assessment of the quality of a company's underlying business (quality). We also examine how well placed a company is for change that it expects to occur in the industry (change). The answers that emerge from this analysis lead to a decision on whether we could potentially buy the company's stock.

However, that does not mean that the fund must then buy it. For that decision, we rely on the other two pillars of the process. Do we have a non-consensus view of the company and know something that is not widely appreciated (insight)? Last, we look at the valuation of the company (valuation).

ESG considerations are integrated into every stage of the process—they are not a separate fifth pillar. For example, the ESG practices of a company can be used as a competitive edge, which enhances the quality of the business. In the case of Symrise, it would now be very difficult for the company's competitors to replicate the changes it began to implement 20 years ago. We have also found that sustainable business practices tend to increase the terminal value of a business. And a higher terminal value means a lower cost of capital or a higher multiple on the stock.

Exploration, Fundamentals and Valuation

In addition to the four-pillar process, the team employs another method for assessing stocks with a big ESG component—because not everything that shines "green" turns out to be an ESG winner. We must determine whether a company is greenwashing, that is, claiming a big boost from ESG practices it does not actually perform.

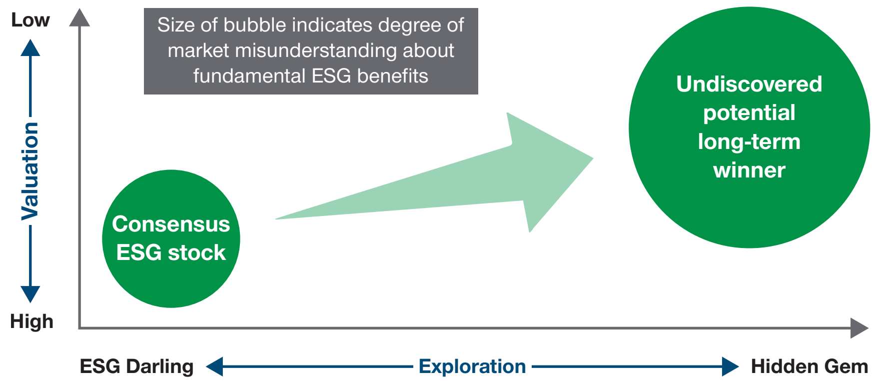
Figure 4 illustrates three questions that we ask when we think ESG considerations are an important part of the investment case in the selection process.

The first question, represented on the x-axis of the chart, is: Who knows about it? Is it an ESG darling because everyone knows about its ESG attributes, or is it a hidden gem?

The second question is: Does it matter to the fundamental model? Do the ESG benefits have a real impact on the financial model, or are they just part of a nice narrative that is unlikely to have a material impact in the years ahead? This is represented by the bubble. A large bubble indicates that the impact on the business is likely to be sizable, while a small one indicates that the effect will probably be negligible.

Foundations of ESG Investing: Exploration, Fundamentals and Valuation

(Fig. 4) Specific considerations for ESG stock picking



For illustrative purposes only.
Source: T. Rowe Price.

The third question is represented on the y-axis: What is the current valuation? A consensus ESG stock is likely to be accompanied by a high valuation, while an undiscovered, potential long-term winner will probably have a low valuation.

Strong ESG Profile

The Responsible European Select Equity Fund is a Responsible SICAV fund, which promotes ESG characteristics by applying exclusion screens. More importantly, our investment approach helps us to create a portfolio with a strong ESG profile.

All except one of the portfolio's current holdings are rated green—the top compliance score—by our RIIM analysis, (which is designed as a tool for ESG integration). We estimate that well over 50% of revenues are derived from sustainable sources. The fund's carbon footprint, based on scope 1 and 2 emissions, is judged to be 85% less than the benchmark.

The fund is rated by third-party providers as having best-in-class ESG integration. MSCI has awarded the fund the highest ESG rating, AAA, and Morningstar has bestowed a sustainability rating of 4 out of 5 globes.

A Positive Decade Ahead

Europe is a pioneer in ESG and sustainability efforts, which are only now becoming more salient in the U.S. and the Asia Pacific region. Companies have had to respond to investors, regulations and society over the last years, and as a result, the Old Continent is becoming a New World that is producing many ESG leaders. This reinforces my positive thinking about European equities over the next decade.

Past performance is not a reliable indicator of future performance.

Objective

To increase the value of its shares, over the long term, through growth in the value of its investments.

Investment Policy

The fund is actively managed and invests mainly in a high-conviction portfolio of shares of European companies. Although the fund does not have sustainable investment as an objective, the promotion of environmental and social characteristics is achieved through the investment manager's avoidance of sectors or companies, whose activities may be considered harmful to the environment and/or society, through the application of its proprietary socially responsible screen (exclusion list). As a consequence, specific companies whose business activities involve controversial weapons (cluster munitions; anti-personnel mines; incendiary, chemical, biological, and nuclear weapons), tobacco production, coal production, assault-style weapons for civilian use, adult entertainment, direct gambling operations, and certain conduct-based criteria are excluded. The fund may use derivatives for hedging and efficient portfolio management. For full investment objective and policy details, refer to the prospectus. The manager is not constrained by the fund's benchmark.

Risks—The following risks are materially relevant to the fund (refer to the prospectus for further details):

Currency—Currency exchange rate movements could reduce investment gains or increase investment losses.

Issuer concentration—Issuer concentration risk may result in performance being more strongly affected by any business, industry, economic, financial, or market conditions affecting those issuers in which the fund's assets are concentrated.

Small- and mid-cap—Small and mid-size company stock prices can be more volatile than stock prices of larger companies.

Style—Style risk may impact performance as different investment styles go into and out of favor depending on market conditions and investor sentiment.

Volatility—The performance of the fund has a risk of high volatility.

General Fund Risks

Equity—Equities can lose value rapidly for a variety of reasons and can remain at low prices indefinitely.

ESG and sustainability—ESG and sustainability risk may result in a material negative impact on the value of an investment and performance of the fund.

Geographic concentration—Geographic concentration risk may result in performance being more strongly affected by any social, political, economic, environmental, or market conditions affecting those countries or regions in which the fund's assets are concentrated.

Hedging—Hedging measures involve costs and may work imperfectly, may not be feasible at times, or may fail completely.

Investment fund—Investing in funds involves certain risks an investor would not face if investing in markets directly.

Management—Management risk may result in potential conflicts of interest relating to the obligations of the investment manager.

Market—Market risk may subject the fund to experience losses caused by unexpected changes in a wide variety of factors.

Operational—Operational risk may cause losses as a result of incidents caused by people, systems, and/or processes.

INVEST WITH CONFIDENCE℠

T. Rowe Price focuses on delivering investment management excellence that investors can rely on—now and over the long term.

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Please note that the Fund typically has a risk of high volatility.

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