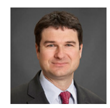
Prepare for the Sustainability Capital Wave

It could rival the Industrial Revolution in scale.

August 2023

KEY INSIGHTS

- A new capital markets wave has begun as countries seek to reduce their CO_2 emissions and mitigate the impact of climate change.
- Companies are realizing that being thoughtful about reducing carbon consumption can help them to lower costs, manage risk, and drive improved returns.
- We believe there will be opportunities to gain attractive, durable returns from companies that deploy technologies and solutions to support the adoption of renewable energy sources.



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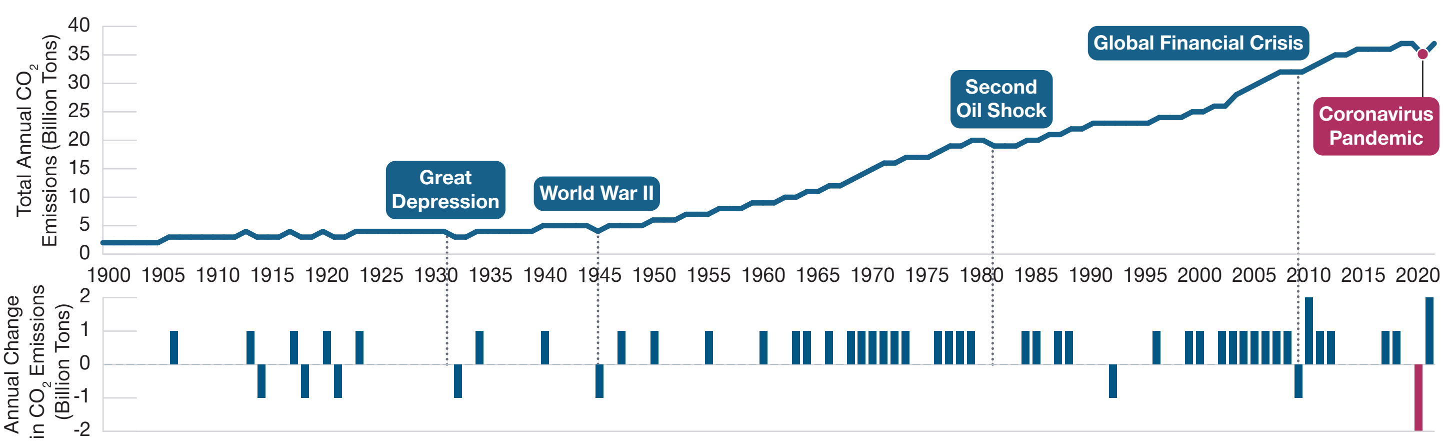
Long-lasting cycles have surged through markets over the past 250 years, providing investors with extended waves of capital to surf. Industrialization, globalization, technological innovation, and shifting demographics have all instigated sustained periods of investment that have ultimately transformed societies. We believe the global effort to reduce carbon emissions may deliver another such wave with similarly profound consequences.

The World Faces an Enormous Environmental Challenge

(Fig. 1) CO_2 emissions have soared since World War II



As of December 31, 2020.
Source: Our World in Data, Global Carbon Budget (2022).

> ...firms are increasingly finding that sustainable practices improve bottom-line performance.
>
> **— Justin Thomson**
> *CIO, International Equities*

The challenge is enormous. According to the Intergovernmental Panel on Climate Change, the target of keeping global warming to 1.5°C above pre-Industrial Revolution levels will require about 50% less greenhouse gas emissions (of which carbon dioxide composes around 75%) in the next eight years. The United Nations has estimated that, for the global energy sector, the target of achieving net zero CO_2 emissions by 2050 will cost around USD 3 trillion annually until then.

In our view, a new capital markets wave has begun as countries seek to reduce their CO_2 emissions and mitigate the impact of climate change. This wave will see capital allocated to reduce carbon consumption as part of an extended period of transition to renewable energy. There are few quick fixes available, and budgets are clearly under duress as we tackle an inflationary impulse and other post-pandemic challenges, yet we believe this wave will only gather momentum in the years ahead as the effects of climate change continue to impact societies in myriad ways. For the patient investor, we believe there will be opportunities to gain attractive, durable returns from companies that deploy technologies and solutions to support the adoption of renewable energy sources.

Finance Will Be a Critical Enabler

Crucially, these opportunities are not dependent on continued political progress in tackling climate change. Although policies like the U.S. Inflation Reduction Act and the European Green Deal are very important and should lead to trillions of dollars of investment over the long term, political leadership on climate change has generally been patchy and has prompted many gloomy headlines in recent years. And given that global coordination on the climate is notoriously hard to achieve, further frustration cannot be ruled out.

Away from politics, however, the private sector continues to forge ahead with innovative ways to reduce emissions and drive sustainability. While in the past such efforts may have been driven by public relations concerns or the availability of tax incentives, firms are increasingly finding that sustainable practices improve bottom-line performance. According to a global study of 500 companies published last year by Japanese telecommunications firm NTT, 44% of firms reported improved profitability due to a greater focus on sustainability. The report claimed that companies now view sustainability programs as imperative to delivering better financial results as well as positive social change.

Research from Ernst & Young, also published last year, claimed that: "Properly maintained equipment operates more efficiently and generates less waste. In addition to driving down costs, organizations that market their sustainable operations will improve their connection to consumers and increase growth.

"Ultimately, organizations that can drive down costs through more sustainable production and operations will not only survive but will emerge as leaders in both top-line growth and having tremendous impact to the bottom line," the report added.

This is a key factor in driving the sustainability wave. If sustainability is regarded as a trade-off with making money, there will always be a limit to how much firms are willing to commit to it. If it is considered a more effective way of making money, however, that commitment is likely to be unwavering. As the reports from NTT and Ernst & Young suggest, more firms are beginning to understand that helping the climate and achieving better returns are not mutually exclusive.

HVAC manufacturers are 'sustainability enablers'....

— **Christopher Vost**
Investment Analyst,
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A good example of this is heating, ventilation, air conditioning (HVAC), and refrigeration systems. CO_2 emissions from building operations have increased in recent years, mainly because of increased usage of heating and cooling equipment. Companies that develop systems that improve energy efficiency in commercial and residential buildings and in refrigerated transportation help building and transport operators to reduce their CO_2 emissions. While all HVAC manufacturers must meet certain environmental standards, some are developing technology where energy efficiency comfortably exceeds these standards. While such technology may involve a higher upfront cost, firms that invest in it may find that this is more than offset over the long-term by significantly reduced energy bills.

If, as expected, climate change intensifies in the coming years, the need for such technology will only increase.

Driving Change Through "Sustainability Enablers"

HVAC manufacturers are "sustainability enablers"—i.e., companies that are directly involved in manufacturing a product or providing a solution that enables other firms to reduce their carbon footprint. The most obvious examples of sustainability enablers—and those that command the most attention—are firms that either manufacture renewable energy technology, such as wind turbine and solar panels, or utility providers that invest heavily in renewables. However, the opportunity set is much broader and richer than this.

Equipment rental companies are another good example of sustainability enablers. Many firms require the occasional use of expensive equipment such as plant hire vehicles, cleaning tools, lighting, or portable buildings. It may not be cost-effective for firms to purchase such equipment only to leave it idle most of the time, so many choose to rent instead.

Over the past few years, the equipment rental market has expanded to include higher-quality, more energy-efficient products that were previously unavailable for hire. This greater choice has resulted in many firms deciding that renting high-quality equipment for short periods delivers cost savings over the long term. While the rent versus buy decision will always be partly influenced by prevailing interest rates, there is growing evidence that firms are increasingly choosing to rent equipment because it makes more sense from a business perspective.

It is also better for the environment as less CO_2 emissions will be emitted by manufacturing one industrial vacuum cleaner to be rented out 90% of the time than by manufacturing 10 industrial vacuum cleaners that are owned separately and sit idle most of the time.

Companies that manufacture air compressors are a further example of sustainability enablers. Air compressors are used in a wide range of industrial power tools in manufacturing. In recent years, compressor manufacturers have developed increasingly energy-efficient products in response to stricter regulations on emissions and air quality. As energy prices have surged, demand for these energy-efficient compressors has increased as companies have sought to both reduce their carbon footprint and lower their energy bills. Innovation in the air compressor market has therefore helped firms to meet sustainability goals and reduce costs.

Investing in the Sustainability Revolution

The quantum of money driving global efforts to promote sustainability should continue to build in the years and decades ahead. Governments play a significant role in promoting sustainability and reducing the friction in processes required to reduce the planet's carbon consumption. Equally, firms are increasingly realizing that being thoughtful about reducing carbon consumption is not only good for their multiple stakeholders but it also helps them to reduce costs, manage risk, and discover opportunity and can help drive attractive returns.

We believe the sustainability wave could rival the industrial and technology revolutions in its scale and the impact it has on society. Trillions of dollars will be invested over decades as the world undertakes the enormous changes required to eliminate carbon emissions and switch to renewable energy sources. Identifying the main beneficiaries of this process may lead investors to companies capable of delivering strong returns over the long term.

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