Ecofin Editorial:
Not all decarbonizers are created equal

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Measuring impact by Participants, Partners, and Power Players

Despite the proliferation of strategies focusing on areas like Environmental, Social, and Governance (ESG) and impact, there is no universally agreed-upon manner of defining them by investors. In fact, the rapid recognition of these factors has in many ways only served to muddy the waters. It seems that if you get 100 investors in the room and ask them to define these terms you'll get 100 different answers. There are two schools of thought: ESG as a negative screen – what don't you want in your portfolio and impact is a positive screen – what do you want your portfolio to do?

As an industry, we're well-schooled in evaluating portfolio returns and how to adjust a portfolio in light of that performance. But if you've made the decision that you want at least part of your portfolio to make an impact in managing climate risk, then how would you measure and evaluate success in implementing this? More and more third-party sites are providing some data around a company's overall carbon footprint, but just looking at carbon emissions doesn't necessarily show us that a company is making an impact. It requires a bit of a critical eye to separate impact from gross carbon emissions. Ultimately, we think of our portfolios as intentionally considering the how and why of climate risk as just another investment factor rather than an investment thesis in and of itself, and sort companies in to three levels to reflect that:

Participants: The first order of 'decarbonizers' are companies actively seeking to decarbonize their business in the context of their ordinary business. The case has been made by some that those companies with a faster path of decarbonization have seen outperformance. Consider a large prominent company like Google or Microsoft, leaders on the green electrification of their electricity budget side. An investor is not particularly exposed to that activity within the overall financials of those companies. It is a minor fundamental consideration as compared to their primary business in cloud, in selling value-added online services to consumer companies etc. Conversely, a company like Unilever which has been a progressive decarbonizer in physical business, has had some instances of vocal shareholder discontent saying management is obsessing about the wrong things for generating returns. So while having a strong policy focused on decarbonization within any business is an important factor for inclusion in achieving that impact or sustainability profile many of us want, it is not a driving investment performance issue, at least not in the near or intermediate term.

Partners: The second order is those companies providing decarbonization products and services outright, and these would generally be considered the 'agents of positive change'. These could be solar manufacturing, wind turbine equipment manufacturing, EV battery value chain, etc. Many of these businesses are seeing strong growth, support from government policy, and high levels of interest from investors, resulting in large amounts of investment. Yet despite all this in their favor it is not necessarily helping returns. In fact it might be hurting them, as there is extremely fierce competition due to the very large and growing addressable markets, and as a result there are many cases where these companies are not terribly attractive from a portfolio perspective.

Power Players: The third order is that attractive part, those companies focused on the same decarbonization products and services as the second order but doing so at scale with some more unique characteristics that are more traditionally associated with pillars of durable competitive advantage: higher moats on IP, large physical positions that can be utilized to generate higher returns, and innovation-led success in customer wins. They're providing both impact and returns. We believe that climate-focused investors need to focus on businesses delivering growth and margins, which may seem very simple, but in practice has proven to be more challenging. Of note when going through the process of identifying these type of companies, they can sometimes screen as being moderate or even high carbon emitters. Consider the example of a U.S. utility – under the regulatory regime as it exists, they have a duty to provide power to their specific customer base. If they've been around for several decades or more they likely have some level of coal burning power plants as legacy assets. Those companies transitioning away from coal to lower or zero-emitting alternatives are going to be making some of the biggest impact possible in this arena but but these investments won't immediately rewrite their entire emissions profile. Even those that are further along in their transition likely still have gas power plants to help manage the intermittency around wind and solar renewables, meaning that their emissions numbers won't look favorable next to the aforementioned Google and Microsoft, but their impact will be orders of magnitude larger.

Of course, data is extremely important when considering impact and will only become more so. It is still messy in many ways and exists in proprietary models more often than not. When comparing impact measurement to return measurement the former is just not as black and white as the latter and as a result is still more "art" than pure "science". Delivering data that helps to measure impact is an enormous change and challenge for companies and investors, let alone regulators tasked with designing the systems to analyze and measure key sustainability data. While that does make for a fairly inefficient market when it comes to measuring impact, it also provides a tremendous opportunity for managers and investors who dedicate time and resources to identifying those companies.

It's also helpful to keep the big picture in mind. This was reflected in the critique Tesla made in regard to ESG in a statement earlier this year. To paraphrase, focus on the totality of a business and what it does. Don't just look at something like a company's existing Scope 1 emission position versus peers and then jump to the potentially flawed empirical conclusion such a comp could lead to. It is natural that companies growing very quickly from a lower base are going to have rapid comprehensive emission growth vs older larger companies which were dirty and are getting cleaner. Does that make the younger emission grower 'bad'? No, not necessarily. Particularly if their products are revolutionising the world in some positive way.

It's better to be a Participant than to not be managing climate risk at all, but true impact in the climate space comes from the Partners and Power Players that are enabling decarbonization en masse and are providing the products and services that allow the Participants to play their part.