Rothschild & Co
Global Advisory

Global Advisory - ESG Newsletter

February 2023 – Edition 2

- **Transatlantic subsidy and investment battle in clean technology is expected to intensify:** EU 'Green Deal' legislation coming in H1 2023. Looking to compete with the climate funding created by the 2022 US $369bn Inflation Reduction Act
- **Challenges of access to the critical minerals required to enable transition solutions becoming more acute:** (Issues include opposition due to environmental impact, geopolitical security risks and uncertainty around technology)
- **ESG activist challenges rising:** Seen in c75% of 2022 shareholder campaigns, but not yet resonating in terms of actual votes
- **Increasing ESG trust deficit and greenwashing concerns** with stricter reporting requirements for funds and corporates
- **Awareness growing around Biodiversity**: Investors, Competition and Markets Authority and NGO's taking more interest in what companies are doing and reporting
- **Surge in private energy transition and impact fundraising in 2022**; By some reports the sub-sector made up c55% of all private fundraising in 2022. The overall number of deals fell, the size of deals increased. Dry powder is building for alternative energy, technology, waste reduction and social impact investing

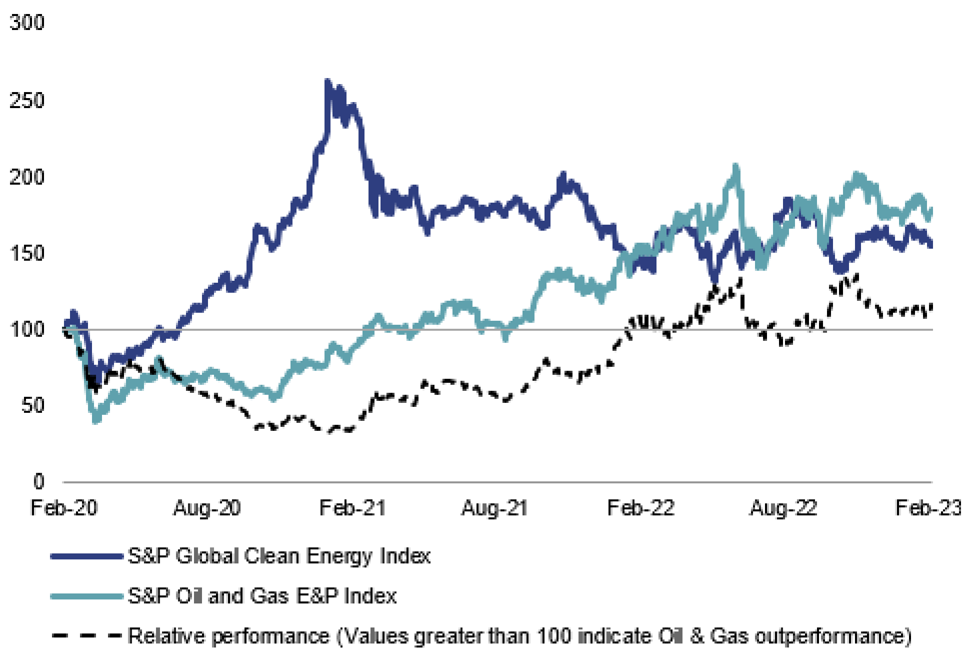
1. Global Themes

The bold US initiatives to boost investment in climate technology has led to debate over subsidies and a response in Europe with the planned EU 'Green Deal' legislation

- **EU and US tension around 'green subsidy race' rising** as Europe awaits detailed legislation and proposals in H1 '23 to execute its Green Deal Plan. This is designed to make *"Europe the home of cleantech and industrial innovation on the road to net zero"*
- **EU will focus on cutting red tape, raising investment funds and promoting skills and trade** – The EU anticipates 2.5 million additional jobs by 2030 if Green Deal targets are met

- **Three recent pieces of US legislation - the Infrastructure Investment and Jobs Act, the CHIPS and Science Act, and the Inflation Reduction Act mean that US government spending on climate technology and clean energy should more than triple in the next 10 years.** These acts contain more than $500bn of climate spending pledges
- The **Inflation Reduction Act (IRA)** announced in Summer '22 outlined $369bn of tax breaks and investment aimed at clean energy and on reducing US dependence on China for key components like car batteries
- The **Creating Helpful Incentives to Produce Semiconductors and Science Act of 2022 (CHIPS and Science Act),** signed into law in August 2022, directs $280bn in spending over the next ten years towards investments in US semiconductor manufacturing capacity. It also seeks to accelerate R&D and commercialization of technologies, such as quantum computing, AI, clean energy, and nanotechnology
- The **Infrastructure Investment and Jobs Act** was signed into law in November 2021.The main thrust of its $550bn incremental spending is to build infrastructure (roads, bridges, public transit, railways etc). There is also considerable provision for incremental spend on clean technologies. The bill includes provision for spending of $21bn on environmental projects, $50bn for water storage and $15bn for electric vehicles. There is an intention to spend $73bn on power infrastructure including the electrical grid's adjustment to renewable energy
- **Numerous countries establishing strategies to secure the supply of critical minerals necessary for modern technologies:** China produces c75% of the world's batteries. The EU and US lag with 16% and 7% shares respectively. ESG policies are being promoted to improve responsible business. Specific projects are facing significant local stakeholder opposition over perceived environmental impacts and delays
- **The IRA is impacting geographic capital allocation decisions by corporates** : Marvel Fusion, a rare EU pioneer in zero-carbon fusion power is being pressured by investors to relocate to the US to take advantage of the $1.4bn earmarked for the domestic fusion industry. Tesla paused battery cell production in Germany in September 2022 to take advantage of US tax credits
- Europe currently manufactures 25% of the world's Electric Vehicles (EV). The US currently produces 10%. Post the Inflation Reduction Act (IRA) electric cars assembled in US qualify for a $7,500 tax break. Car parts made in the EU get nothing
- **US ESG backlash polarised and complicated**; Some States are passing laws to support ESG investment while others are publicly condemning ESG approaches and withdrawing funds. Florida withdrew $2bn in Dec '22 from Blackrock on concern at its perceived anti-fossil fuel stance. Texas introduced legislation in '21 against banks/asset managers perceived to be anti-fossil fuel - inadvertently leading to higher borrowing costs for Texas due to banks withdrawing, according to a UPENN study

Oil & Gas vs. renewables relative performance over last 3 years



Source: Factset

- **Biodiversity awareness growing:** Task Force for Nature Based Disclosures are due to be released in March '23 with a proposed new management and disclosure framework ahead of the full framework for market adoption in Sept '23. TFND estimates 50% plus of the world's economic output is moderately or highly dependent on nature. The TFND is looking to help organisations manage, report and act on nature related risks. As with the TFCD (Task Force for Climate Focused Disclosures), TFND considerations are expected to become a broader part of global companies' focus and reporting in future and an influence on the investment narrative

- A BCG Report estimates pursuing nature positive transitions could generate $10.1trn in annual business value and create 395 million jobs by 2030

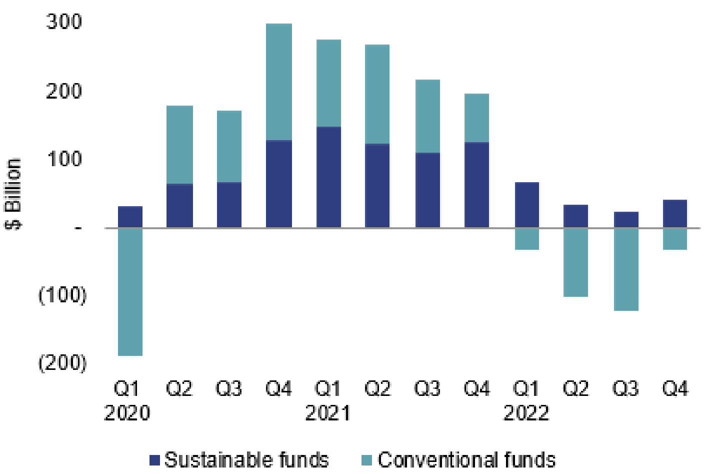
2. Public market trends

Clear focus on returns in transition related investment, ESG activism rising but not always resonating, conflicting/polarising institutional investment forces at work, ESG equity and debt assets returning to growth, regulation rising and CSRD adopted at the end of 2022

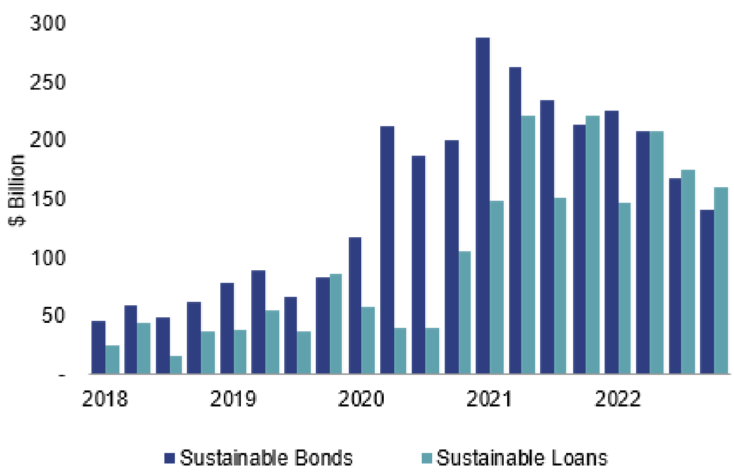
- **BP rose 8% on FY results in February** (2-year high) after scaling back its 2030 oil and gas reductions targets – an example of focus amongst equity investors on transparency around investment hurdles and returns on investment
- **Share buybacks at record levels** – US tripled y.o.y in Jan '23 to $132bn with announced buybacks including $75bn from Chevron
- **Shell's Board of Directors are being personally sued in a civil action by ClientEarth.** The action is being supported by some pension funds and institutional shareholders. The first case of its kind at the UK high court for a claimed breach of a company's legal duties under the Companies Act in failing to adopt and implement a Paris aligned energy transition strategy. **ClientEarth have also launched a legal challenge against the UK regulator and have alleged the FCA unlawfully approved the Ithaca PLC prospectus** which failed to adequately describe climate risks.
- **Growing ESG trend in the Tech sector.** Among the firms signing clean energy deals in 2022, dominating the renewable energy purchasing power agreement space was Amazon: close to 11GW; Meta: 2.6GW; Google: 1.6GW; Microsoft: 1.3GW (in aggregate representing approx. 46% of the market). Technology companies specifically need to continue buying clear energy. In total, corporations have signed PPA's for 148GW of clean power since 2008 – more than the total power-generating capacity of France
- **72% activist campaigns in 2022 were ESG linked**, broadly consistent with the previous year
- **E&S campaigns failed to achieve required support when not directly linked to value.** RWE failed coal spin off gained only 2.4% support; AGL energy demerger plan met with 75% opposition; Carl Icahn conceded the proxy fight on treatment of pregnant pigs at grocery chain Kroger Co. after losing a similar battle with McDonalds in 2022
- **Growing threat of climate litigation, an 'ESG trust deficit' and green washing risk;** Questions are being raised as to whether companies really do deliver positive impact with accusations of unclear and overstated ESG credentials. Regulators have raised concerns around ESG benchmarks and credit sensitive rates; CMA and NGO's are paying much closer attention to what companies are doing. HSBC has recently added greenwashing to it risk matrix after the UK's Advertising Standards Authority banned 2 out of home adverts on the grounds that their environmental claims could be misleading. ESG risks including climate risk are raising concerns around legal challenges on banks: BNP has been hit with the first ever climate suit to be filed against a commercial bank, and is being sued by a consortium of 3 French NGO's,
- Requisite climate and environmental reporting standards for corporates and funds came into force in Nov '22, setting **targets against the TCFD (Task Force on Climate-Related Financial Disclosure) as market standard**
- **Corporate Sustainability Reporting Directive (CSRD).** These new reporting rules entered into force 5th Jan '23
    - for companies engaged in EU business activities. It requires over 50,000 EU companies to report on the impact of climate change
- **EU Sustainable Finance Disclosure Regulation (SFDR) level 2 rules for funds brought into effect 1st Jan '23;** This aims to improve transparency for sustainable investment products, prevent greenwashing and increase sustainability claims
- **French corporate governance regulator (AFEP-MEDEF) revised guidelines in Jan '23** to recommend French listed corporates integrate CSR objectives. These include having at least one climate objective in executive compensation, CSR Committees at Board level, and multi annual strategic CSR plans and targets

- **Global sustainable fund assets recovered to $2.5 trillion at the end of December** This figure represents open-end funds and exchange-traded funds that, by prospectus or other regulatory filings, focus on sustainability; impact; or ESG factors. The figure was up on the $2.24 trillion at Q3 2022 . The12% increase ended three quarters of asset decline and

Sustainable equity fund flows vs. conventional equity fund flows



Sustainable bond and loan issuance



Sources: Morningstar Direct, Manager Research, Data as of '22, Refinitiv

was almost double the growth of the broader global fund market; EU Article 8 funds returned to inflows; net new money exceeded € 10.7bn

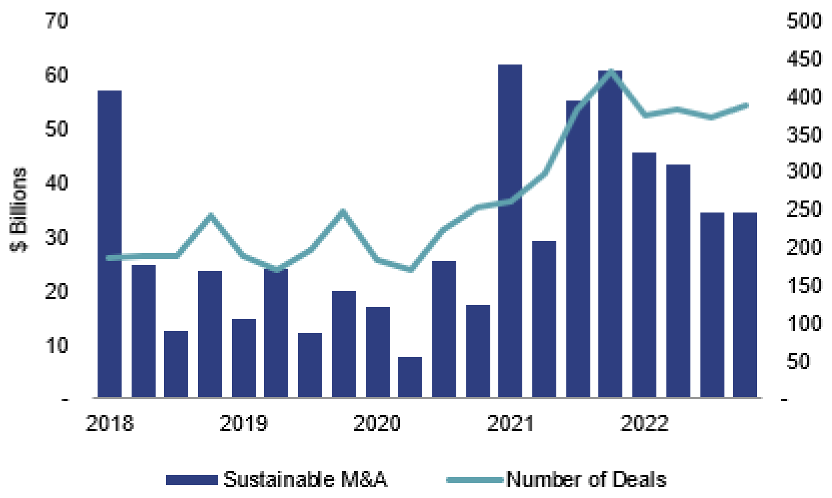
- **Global sustainable debt issuance totalled $744 billion in 2022**, **down 26% from 2021**; Green/climate finance was widely recognised as needing more clarity and transparency. The current architecture leaves issuers to self-define what is 'green'; recent studies suggest green bonds generally do not differ either by rate of return or legal structures/covenants. The emerging disagreements could undermine the credibility of the green finance framework

3. Private Market Themes

High levels of capital waiting to be deployed in Impact and Infra Funds, deal sizes increasing and focus on alternative energy and technology, waste reduction and social impact

- **2022 was notable for a surge in energy transition and impact fundraising,** making up 55% of all sector specific fund raising in 2022. Substantial dry powder continues to build. There was a reduced volume of deals but increased average deal sizes. Brookfield closed its debut global energy transition fund at $15bn, twice the original target size; TPG's debut climate fund raised $7.3bn vs. its targeted $5bn; and KKR Fund 2is already 45% larger than its inaugural impact fund of $1.3bn which reportedly earned gross IRR 39.4% and net IRR 28.9% in June 2022
- **Infrastructure fundraising hit a post-pandemic high in 2022** surpassing the $156bn raised in 2021. Digital transformation pivotal to infra projects and energy transition
- Private infrastructure funds are increasingly expected to deliver competitive returns. However, projects have been impacted by supply chain issues and hard to abate emissions. The capital intensive nature of projects, and scale-ups, combined with rising leverage levels and policy risk is reflected in an overall slow-down in activity levels.
- M&A activity involving sustainable companies totalled US$159.3 billion in 2022, a 24% decline compared to 2021 and a two-year low. This was a robust relative performance in a global M&A market which declined 48%

Sustainability linked M&A deals (energy transition linked including water/waste efficiency



Source: Refinitiv

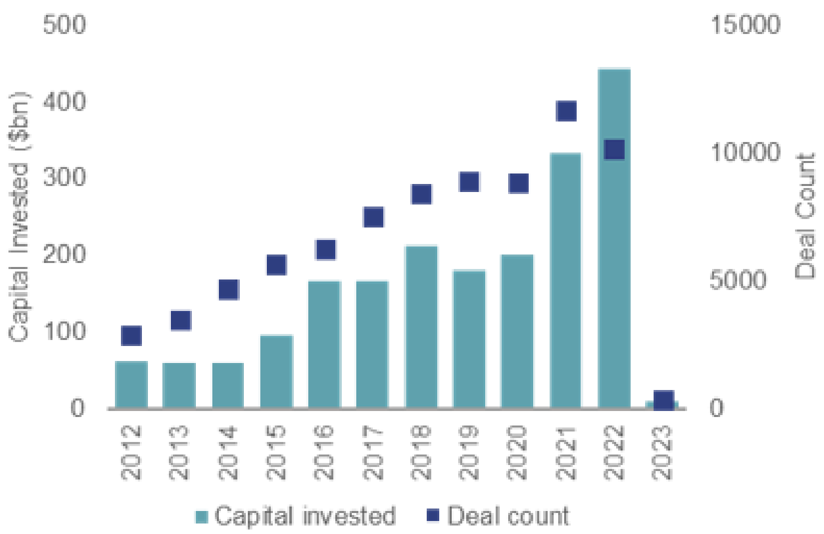
Four clear themes:

(i) Substantial growth potential for companies across an array of renewables value chain – The International Energy Agency expects renewable power to surpass coal generation by 2025 adding as much renewable power in the next 5yrs as in the last 20;

(ii) Tightening and converging global regulations on waste reduction; and

(iii) Shifting demographics having a profound impact on future investing; The number of over 65yr olds compared to under 5's predicted to double by 2050. Strategies have multiple pillars including healthcare, education and innovation where automation and productivity tools are key; companies look to manage falling working population, maintain margins and grow profit

deals exposed to 'eco-friendly' industries (recycling, end of life, solar, EVs, renewables, automation)



Source: Pitchbook

(iv) PE impact decision making rooted in proprietary ESG frameworks; A growing number of funds adhering to recognisable initiatives - Net Zero Asset Manager, science-based target initiatives, SDG's, PRI and Operating Principles for Impact Management - focus on operational optimisation and requirements for exit strategies. Application of ESG criteria in private investing under fire in actions and statements of some US pensions including Florida State Board of Administration

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