Global Advisory ESG Newsletter

June 2023 – Edition 3

1. Global Market Themes – competition and regulation

Geopolitical competition on low carbon subsidies and investment continues with the UK Government publishing the UK's energy transition plan in March 2023, following the US Inflation Reduction Act (IRA), EU Industrial Green Deal, and Japan's green transformation plans. All of these packages are likely to impact the **flows of sustainable capital** and **growth considerations** of clients operating in multiple jurisdictions. The EU also passed the **Critical Raw Materials Act** to **help scale EU manufacturing of key carbon neutral technologies** and reduce dependency on non-EU countries

- **Delivering on the EU Green Deal:**
  - Discussions amongst **corporate clients reveal challenges** in navigating the dynamic nature of the Corporate Sustainability Report Directive (CSRD) regulations and its strategic implications. Consultation on the draft of the European Sustainability Report Standards (ESRS) will be open until 7th July, ahead of fully finalising the standards, with a risk they may be watered down due to **low corporate CSRD readiness**
  - Earlier this month, **the European Parliament adopted the Corporate Sustainability Due Diligence Directive (CSDDD),** imposing obligations on companies and directors to **assess and address human rights and environmental impacts across their supply chain.** The rule will apply to EU-based companies and non-EU companies under certain conditions, and negotiations with members states is due to begin
  - **Failure to comply** could make companies vulnerable to **litigation** and we expect Companies to undertake **critical reviews of supply chains and approach to vertical integration**

- In April, the EU Parliament adopted 5 key pieces of legislation to accelerate decarbonisation as part of the '**Fit for 55' package**, which will enable the EU to reduce its net greenhouse gas emissions by at least 55% by 2030 compared to 1990 levels and achieve climate neutrality in 2050. These include widening the scope of the EU's Emissions Trading System, creating a separate new ETS II for fuel for road transport and buildings, phasing out emission allowances in the aviation sector and adoption of global carbon offsetting, implementing a Carbon Border Adjustment Mechanism (CBAM) to protect select EU industry and importers of goods, and creating a new Social Climate Fund to be used by member states
- In May, the **EU Deforestation Regulation was adopted by the EU Council**. By setting mandatory due diligence rules, the new law obliges companies to ensure products sold in the EU have not led to deforestation and forest degradation.
- The **EU Taxonomy was extended beyond climate objectives** in June and, in parallel, **expanded on economic activities contributing to climate change mitigation and adaption not included so far - in particular in the manufacturing and transport sectors**, to further facilitate transition finance opportunities

- **DEVELOPMENTS IN THE UK** – the **UK** government published **"Powering up Britain"** in March, **a blueprint for the future of energy**. This includes a £20bn investment for CCUS, a roadmap for hydrogen alongside a dedicated £240m Net Zero Fund, the launching of Great British Nuclear to support the UK's nuclear industry, a floating offshore wind plan (including a £160m Port Infrastructure Fund), the Great British Insulation Scheme to promote energy efficiency– and the inclusion of a Transition Finance Market Review seeking to make the UK the best place in the world to raise transition capital
- **BIODIVERSITY** – continued momentum around awareness of economic dependency on natural capital with **risk disclosure** frameworks and regulation advancing, impacting corporate disclosures and supply chain risk perceptions
  - **Taskforce on Nature-related Financial Disclosures (TNFD) final framework expected in September 2023**. Its recommendations will likely shape **voluntary corporate disclosures** on the assessment of **nature-related risks and opportunities**, just as TCFD has done on climate
  - **Science Based Targets for Nature beta released** in May, **allowing the impact of companies' operations on nature to be estimated against a standardised disclosure Framework.** The data will be used to hold businesses accountable for their impacts on biodiversity, and assess whether company targets align with the UN SDGs
- **GREENWASHING** – push for more regulation across industries
  - In response to greenwashing risks on **carbon offsets** the Integrity Council for the Voluntary Carbon Market (ICVCM) released its **principles for voluntary carbon credits** in March to **try and restore confidence** after Verra, a leading carbon credit certifier, was subject to greenwashing criticism earlier this year. The criticism likened Verra's rainforest offsets, among the most commonly used by companies, to 'phantom credits'
  - In the **UK**, the Advertising Standards Authority's (ASA) is set to **ban adverts claiming carbon neutrality achieved through carbon offsetting** and has highlighted campaigns in 2023 by Shell, Repsol, Ethihad, Lufthansa Petronas for misleading ESG claims

- After an initial exodus of a number of asset managers from the Net Zero Asset manager initiative, we have seen the **continued exit of some of the biggest members** in the **Net-zero insurance alliance**, amidst fears of antitrust lawsuits and criticism from US Republican politicians

- **ESG RATINGS** – more specialisation and more scrutiny being placed on corporate climate disclosures and ratings

- **ESG rating providers are developing separate climate ratings** to address investor demand for specific climate risk and opportunity evaluations. Sustainalytics (a leading provider of ESG ratings) launched new Low Carbon Transition Ratings in April, initially covering the largest 4000 public companies

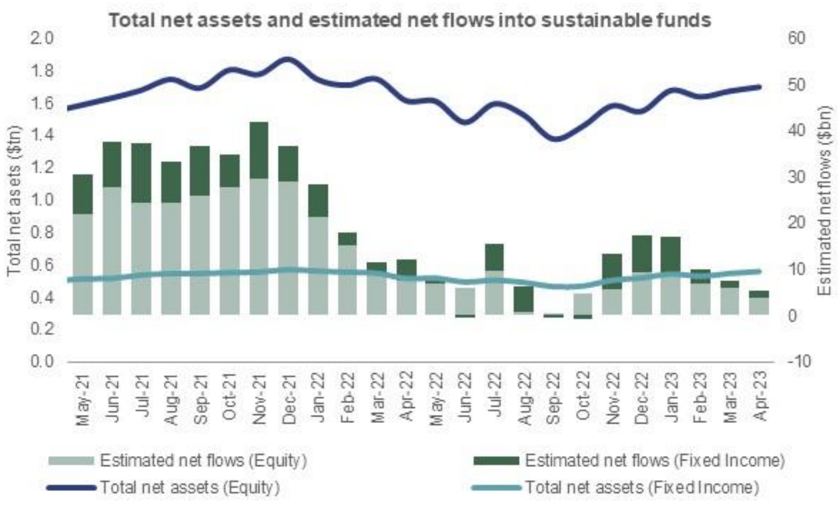
- **The European commission published a proposal** in June, which aims **to "increase the integrity of the operations of ESG rating providers" via new organisational principles and clear rules**. Regulation of ESG rating providers is looming large. The UK Treasury has also launched a consultation on the future regulatory regime of ESG ratings providers with the goal of standardising ESG ratings

- **Speculation around the focus COP28 and potential outcomes** continues with 5 months to go- at this stage the event is attracting publicity around attendance of the Syrian President and tension around the role of 'big oil' in the transition. The Paris climate finance summit in June has tried to **start mediating the North-South financing commitments** and this topic is set to receive increasing attention ahead of COP28 around the Loss and Damage Fund and the outcome of a Global Stocktake to measure progress to net zero, which looks increasingly under pressure and ongoing debates around role of carbon capture and the level of absolute emissions

2. Public Market Themes

2023 AGM SEASON – showing the ESG shareholder resolution divergence across geographies with US backlash

- **Global sustainable fund flows have been positive YTD** and have made a recovery since 2022. Throughout 2023, fund flows have contributed an average monthly growth rate of 0.4% for sustainable equity funds, and 0.7% for sustainable fixed income funds



***Source**: Morningstar*

- **2023 has seen record numbers of ESG shareholder resolutions in the US and lower number in Europe year on year**. US resolutions received less support this season on average (23% in 2023 vs 36.6% in 2022) and only slightly more support in Europe (11.6% average in 2023 vs 10.6% in 2022) despite high profile coalitions of investors with public campaigns

- **Climate Action 100+, the world's largest investor-led engagement initiative launched Phase 2 of Investor engagement**, moving from 'words to action' and providing the 700 signatories with $68trn AUM with tools to hold companies to account on the implementation of plans for 100 largest carbon emitters
- Phase 2 is likely to see **increased tension with companies**, illustrated by a recent response from Exxon to Glass Lewis in May, which pushed back on a shareholder resolution supported by Glass Lewis, highlighting that **the prospect of the world achieving net zero carbon emissions by 2050 is remote and should not be further evaluated in its financial statements – Exxon and Chevron's shareholders rejected resolutions for more stringent medium-term Scope 3 (end-use) emissions targets** for the US majors which generated 11% support Exxon and 10% at Chevron. Similar proposals last year achieved 28% of the vote at Exxon and 33% at Chevron
- In the energy sector there has been a shift amongst some of the listed major European energy Companies adjusting from declining production to a near term growth narrative and also included the largest acquisition of assets in the listed space for some time with Neptune Energy Group's gas focused assets, acquired by ENI and Var Energi for $4.9bn (Rothchild &Co advised Neptune Energy and its shareholders)

3. Private Market Themes

PRIVATE MARKET DEAL ACTIVITY – carbon and emissions technology in Q1'23 was strong with new themes emerging

- **Largest Carbon & Emissions deals in Q1'23** include the $881 million venture growth round for Generate, a sustainable infrastructure developer, and a $200 million late-stage VC funding for Peak Power, a developer of energy-optimisation software for buildings
- **Carbon accounting and measurement start-ups are an emerging investment responding to increasing demands for transparency and measurement of carbon emissions –** Venture Capital investment in the sector has grown substantially over the past 3 years, increasing from $55 million in 2020 to $766 million in 2022
- **Electric storage and mobility start-ups have also received significant private stage funding during Q2'23**
    - Charge Zone, a developer of electronic charging network software, raised $100m Series A2 funding
    - DriveCo, developer of electric vehicle charging systems intended to charge vehicles through solar energy, raised €250 million of Private Equity funding from APG
    - JOLT Energy, producer of ultra-fast charging stations, raised €150 million to start building an urban ultra-fast charging network and install thousands of the company battery buffered HPC stations in Europe and the US
- **Water sector saw its first unicorn, Gradiant**, who announced a $225mn funding round, valuing the company at $1bn. Gradiant have developed new ways to treat industrial wastewater
- **Climate focussed investment split across a broad range of private market subsectors between 2019-2022, including:**
    - Power (50% deployed capital, with investment doubling from $40-$100bn)
    - Transportation (370% increase in investment from $6bn to c.$30bn)

  - Hydrogen (3% total climate focussed private equity investments in 2022, from $1bn-$5bn in 2019-2022)

  - Carbon management (3% total climate focussed private equity investments in 2022, from <$500m-$7bn in 2019-2022 increase)

- **Upward pressure on asset values due to competition from large corporates**, particularly from energy companies i.e., BP America's purchase of Archaea Energy for c.$4.1bn, Chevron's acquisition of Renewable Energy Group for c.$3.2bn (Source: McKinsey)
- **Increased focus on private market investments to enable a shift from 'brown to green'** including fossil-fuel businesses to more environmentally friendly ones e.g., refineries being transformed into ethanol plants

4. R&Co recent ESG related transactions and projects

- **EcoDataCenter I Dalarna AB**: independent financial advisor to the company in transfer of holdings of majority shareholder. The advice incorporated ESG-related attributes, with EcoDataCenter as the world's first climate positive data centre operator (26/05/2023)
- **Apex Group:** sole financial advisor in the acquisition of MJ Hudson, a provider of management company fund administration, ESG, and data analytics services (12/04/2023)
- **BIDC:** ECOWAS Bank on the design of its ESG Financing Strategy and inaugural Sustainable Finance Framework (27/03/23)
- **Brambles Ltd:** debut green €500m bond (20/03/23)
- **NetZero:** series A fundraising €11m (08/03/2023)
- **OVH SAS:** OVHcloud on its ESG perception study and ESG ratings (06/03/23)
- **Dassault Systemes:** sole ESG ratings advisor in relation to the inaugural ESG score by S&P (03/02/2023)
- **Groupe Primonial:** sole financial advisor in the disposal of La Financiere de L'Echiquier to La Banque Postale Asset Management, a deal which will strengthen the buyers position and product range, enhancing its ESG labelled funds offer (Closing of transaction due Q3 2023)

5. Recent ESG related Investor Feedback

Investors' approaches continue to polarise; 49 anti ESG bills introduced in the US in 2023 and divestment by Church of England of oil & gas investments in the UK – ESG in infra is increasing in importance – introduction of Article 8 / 9 fund classifications remains a work in progress at many institutions with some divergence between active PM's and ESG teams

The quotes featured below illustrate the breadth of views and varying approaches to ESG within different institutions and across geographies; the quotes have been extracted from conversations with investors over the last three months

DISCLOSURE & ENGAGEMENT

*"**A lot of companies have mistakenly over the last few years thought that the more they talk about ESG and their purpose and mission, that is going to help get more shareholders on the register and get their share price up**. As we have learned over the last year, particularly since the war in Ukraine, and since the recession has been looming, and inflation has been high, it is actually that investors want to be sure - first of all - that they are protecting their capital as best they can and hopefully growing it. That is why the oil sector was the best performing sector. If ESG really was such a key determinant of share price performance, then oil and gas would not have been the best performing sector"* - **Long-only manager, London**

- *"**We will engage or vote if we see a material governance issue with a stock, if we believe it will help accelerate value creation,** such as voting against or engaging with a weak management team, but largely will outsource the voting to a proxy advisor"* - **Investment analyst, London**

ESG IN THE INVESTMENT PROCESS

- *"ESG has come really to the forefront of infrastructure managers. There are **certain limits that managers can now have in terms of companies that are not within the framework of net-zero investing**. We really appreciate the companies that have good alignment with their carbon reductions that fall within some science-based pathways and are doing the right thing to decarbonise and basically do well on ESG. Within our framework, we have an assessment of EU taxonomy-aligned and eligible activities. We have the EU Do No Significant Harm assessment. On top of that, we have things like Implied Temperature rating and that performance against the science-based pathways on the carbon emissions reductions that I have spoken about before. All of that needs to have a good end product at the end of the day.*
- *"For us, **I can tell you that we have a target of 100% of our companies need to be aligned with the below two degrees pathway by year 2030. After that year, we will not be able to hold non-aligned companies anymore**"* - **Infrastructure manager, London**
- *"We have a separate ESG team who score companies across our investment universe. **We look for numbers and when we don't find it, we penalise companies.** They are particularly looking for clear KPIs such as water usage and total CO2 emissions etc. The ESG team like to see a director responsible for ESG – someone who takes responsibility for sustainability initiatives at company"* - **Global small cap manager, US**

ARTICLE 8 & 9 FUNDS

- *"On Article 8 and 9 funds, we do have a policy, but we have an **ESG team that will do further evaluation on the companies** as to whether we can invest or not. We combine a lot of third-party data such as SASB, however the ESG team will separate the screening for the company if we're serious about investment"* - **Long-only manager, Hong-Kong**
- *"We did have an Article 9 fund that, with all of this **disclosure and regulation** or whatever, has been downgraded to Article 8. The various portfolio managers discussing alignment with taxonomy is something which will become much more important"* - **Long-only manager, Dublin**

  "The majority of funds are Article 8 and have a high integration across all of their funds. **ESG team has the last word on investment or divestment in a company,** *so this very often leads to clashes between ESG team and PMs"* - **Long-only manager, Paris**

- *"Last year, I would have said, ESG was not so important, but this year, we have an ESG fund. We just launched an ESG fund. We have an Article 8 fund now. Then, for our other funds, we are trying to get all of our funds to at least Article 6, so ESG is becoming increasingly important in our investment process"* **- Infrastructure manager, Sydney**

Additional resources related to Rothschild & Co's sustainability strategy and performance can be found below:

- Rothschild & Co 2022 Sustainability report published in April, view here
- Rothschild & Co 2022 Climate Impact Report is available to view here
- A set of standard slides describing Rothschild & Co's sustainability progress is available to use here
- Resources available for all employees in the R&Co Sustainability Academy, available to view here

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