Analysis

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Weighing the Environmental factor in ESG investing

Key take-aways

- We fully integrate ESG factors into our investment process wherever necessary, as we have been doing for the past 25 years.
- Environmental impact considerations, although still complex to analyse, are becoming easier to cost and measure based on the growing prevalence of corporate plans, standards and concrete government taxes, policies and procedures.
- This makes some of our investment decisions easier through better measurement of the associated costs over time of achieving greater sustainability for each company. In turn, it has a greater impact on our portfolio construction than in the past.
- We also actively engage with our investee companies to better understand their challenges, monitor their sustainability journey and help influence their progress in a meaningful way.

Environmental, social and governance (ESG) considerations have always played a fundamental role in M&G Investments' valuations-based investment process, as part of the many potential risks and opportunities facing all businesses. These factors are reflected in our company valuations as they impact a company's expected future earnings and cash flows. While historically most investors have necessarily paid more attention to the governance side of ESG, in recent years the others – especially environmental – have been playing a more impactful role in some of our investment decisions. Here we explain why this is, and look at some of the specific environmental factors we analyse in building our client portfolios.

More impact from environmental considerations

In the past it was relatively difficult to quantify the future earnings impact of both a government's and a company's environmental policies (if the latter even existed). While this remains a complex area, these days we have many more sources of data, with much more detailed information to analyse regarding environmental risks and future costs for many entities. These stem from governments' clearer and more numerous regulations – including carbon taxes – and companies' own business plans to reduce their impact on the environment, as well as their greater transparency with stakeholders.

The environmental cost of companies' operations has not been taken into account accurately for decades, meaning that the damage that is being done to the planet as a result of carbon emissions and high water usage (among other unsustainable practices) is much higher than the financial cost companies have actually reflected in their financial statements. The result is that future generations will have to pay for the cost of past mistakes, which governments are becoming increasingly aware of. In turn, governments are trying to drive company behaviour towards adopting new models, and to "price" for the damage being done to the planet through different taxes, restrictions and regulations.

In the future, therefore, there will be a real cost to companies based on currently "intangible costs" like tons of carbon emitted. Some companies may so far have saved millions of rands in capital expenditure, which is a real cash cost, by having avoided converting their assets to more carbon-efficient methods, and managed to remain competitive with peers that have decarbonised to some extent. In a world of high carbon taxes, however, the cost to the environment will be reflected in the financials of carbon-emitters. The result? Companies that are more carbon-efficient will gain a major cost advantage over companies that are not, potentially putting high carbon-emitters out of business.

Environmental factors in investing

Climate change, carbon emissions, and water and energy usage are all on our list of factors we use to assess whether a company's earnings will be sustainable going into the future, and how they impact its current valuation. Companies have been getting consistently better about improving their disclosure around ESG, with many publishing their maiden Task Force on Climate-related Financial Disclosures Report (TCFD Report), in which companies detail their climate change strategy and outline different scenarios around greenhouse gas reduction ambitions. Part of our job as investors is to analyse a company's strategy and attempt to answer such questions as:

- Whether the strategy is ambitious enough to remain competitive;
- What capital expenditure (capex) will be needed in the coming years to implement the strategy;

- Whether the company's balance sheet strength (cash) will be able to carry out such capex plans without needing to raise more capital; and
- What the cash cost of carbon emissions would be for the company if carbon taxes were to be raised to levels in line with developed markets.

Banks and capital markets are also becoming more stringent in terms of lending money to companies that have a poor ESG rating, which may drive up the cost of borrowing disproportionately for different players. Certain industries will always be heavier carbon emitters than others, and therefore the key consideration is whether the company will remain competitive within its peer group if it doesn't reduce emissions sufficiently and within a reasonable amount of time. This is not a linear progression, however, given sudden shifts in taxation and the long-term nature of capital projects. Insufficient planning can place a company under significant pressure at short notice.

In reality, the ability of a company to reduce its carbon emissions is certainly not an easy task – sometimes alternatives are just not viable for different reasons, and the landscape for these options is shifting as more investments are made. Constant engagement with management teams to learn about how they are considering transitioning their businesses, learning about their challenges and engaging with them on the importance of ESG is an ongoing part of the analysis.

All these considerations may have a material impact on a company's free cash flows, its future dividends, and the valuation multiple the market will therefore assign to the company. So not only is their environmental impact an important ethical consideration for companies, but it is a key factor for investors in determining what the long-term fair value of a company is and whether we can make money by investing in its shares.

PPC and environmental considerations

PPC, one of the largest cement producers in southern Africa, is one company we are holding in our client portfolios which has large carbon emissions. Cement producers by their nature emit high levels of carbon, around half of which result from the energy-intensive nature of the process and the other half from the chemical reaction that takes place in producing the clinker (called the calcination process, where the limestone is heated to extract the calcium oxide but releases carbon dioxide as a by-product).

One area where much of the reduction in emissions can be achieved over time is from the company's energy sources, but the calcination process is very difficult to adjust: the carbon dioxide emissions from this process cannot yet be viably captured on such a large scale, but using extenders, which leads to less clinker per bag of cement, will play an important role over time.

PPC has a plan to cut its emissions from current levels by 10% by 2025 and by 27% by 2030, and has also committed to reaching net zero (or carbon neutrality) by 2050, as outlined in its latest TCFD Report. It has set aside a budget of some R664 million to achieve its 2025 target in several ways: investing in renewable energies such as wind and solar power to add to its mix of energy sources;

using alternative fuels to coal; and making its plants more efficient, among other initiatives. In time, as technology improves, the need for clinker-based cement products should be reduced; so for us, ensuring that PPC spends enough on research and development is an important element in helping them remain at the forefront of the industry as cement-alternatives become more common. Equally, the success with which they manage and meet their short-term targets is an element we regularly assess, since this gauges their commitment to and sincerity in achieving their long-term goals.

Given that PPC operates across a number of southern African countries outside of South Africa with less sophisticated economies, the group's decarbonisation efforts beyond 2025 will likely become even more costly, unless cheaper technology can be developed. At the same time, its cost of capital could be under pressure to rise should investors opt to avoid carbon emitters. The company has been de-carbonising since 1990, having already cut its CO2 emissions across its power generation system by nearly 30% since then. However, it still pays carbon taxes and faces the likelihood of paying significantly more in the years to come if they do not further reduce their emissions.

In conclusion, this is only a glimpse into the environmental considerations we take into account when conducting our analysis of PPC and other companies. These days "E" factors are playing an increasingly impactful role in our investment process given the availability of more data, and the roles of environmental regulation and taxation. It is still early days in terms of the disclosure and strategies that companies have in place, however – the investment industry has an important part to play in encouraging improvement in this area as it also improves our decision-making ability around a company's longer-term sustainability. Our ultimate goal is to determine whether the company's current market valuation makes sense in light of these additional risks, and consequently whether it is a good candidate to add to our client portfolios. □

Kaitlin joined M&G Investments in early 2015 as an Equity Analyst, where she was responsible for covering stocks in the industrial and consumer discretionary sector as well as a portfolio of African stocks, primarily focused on the banking sector. In addition to being the joint-Portfolio Manager of our African Equity mandates and funds, she is also the joint-Portfolio Manager on the M&G Dividend Maximiser Fund, as well as a portfolio of specialist Select Equity mandates for institutional clients. Prior to joining M&G Investments, Kaitlin completed her articles at Ernst & Young, where she was responsible for auditing companies in the Finance, Gaming and Leisure, Real Estate and Manufacturing sectors. She holds a B.Acc (Stellenbosch), is a Chartered Accountant (CA (SA)), and a Chartered Financial Analyst (CFA Institute).