Global Asset Management
BlueBay Asset Management

RBC European Equity Team Environmental, Social & Governance Report 2022

A look back at ESG in 2021

The ESG landscape was ever-shifting in 2021, with different elements taking centre stage as the pandemic ebbed and flowed. Pressures felt across many levels, including corporate and societal, had an impact. This report analyses these events, as well as looking forward to what will be important throughout 2022.

We have identified clear trends within ESG that are likely to become stronger, aided by a post-pandemic shift in momentum. As investors, our job is to comprehend these nuances, support those we deem important, and position our portfolios accordingly.

One ESG theme prominent in 2021 was regulatory development. Most pertinent to Europe was the progress of the European Green Deal and the bloc's broader plans to combat climate change under the "Fit for 55" banner. These proposals aim to align key policy areas including tax, energy, and transport and to reduce greenhouse gas emissions by at least 55% by 2030, compared with 1990 levels. While they will take time to ratify, these proposals have helped cement Europe as a global leader in sustainable policymaking.

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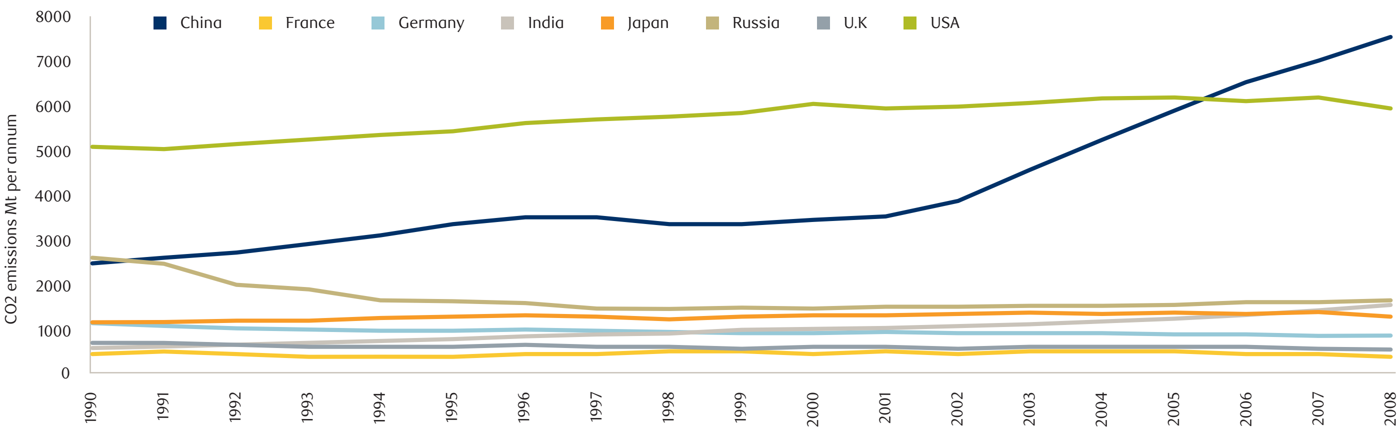
Fig. 1: CO2 emissions by country

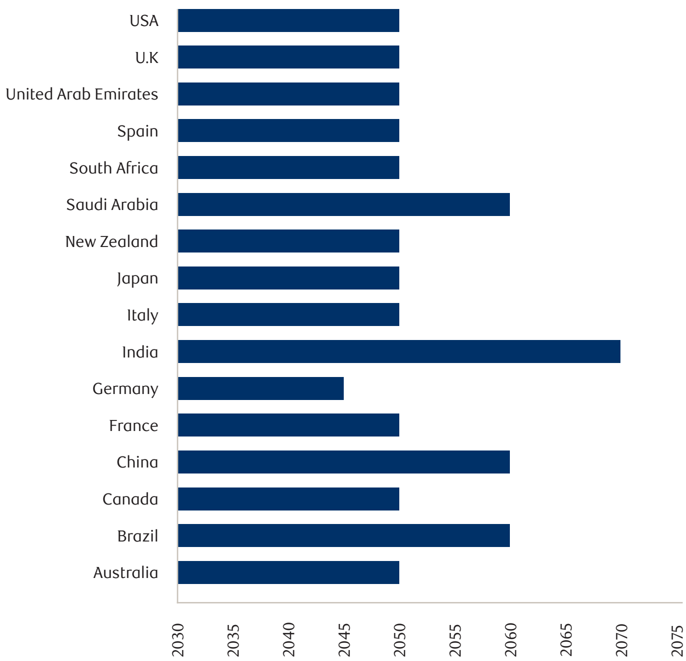


Source: The Global Carbon Project, 2022.

Key in the calendar was COP26, which took place in Glasgow in November. After much expectation and build-up, there was incremental progress. While the 1.5°C target (a goal of limiting global warming to 1.5 degrees Celsius) appeared not to be met with the commitments announced, some large emitters – most notably India – announced either new or revamped targets. Of particular interest was the concluding agreement from the conference, which explicitly mentioned coal, even if this ended up being watered down from "phase out" to "phase down". Countries also committed to pledges including addressing deforestation, financing of oil, coal, and gas, as well as zero-emissions vehicles. The final agreement requested countries to strengthen any 2030 targets by the end of 2022.

2021 saw another year of record sustainable fund growth, as global assets reached US$2.74 trillion, a staggering year-on-year increase of 53%. Sustainable fund launches have correspondingly soared, with the fourth quarter seeing an estimated 266 new sustainable fund launches globally, the majority in Europe. Investors poured US$142 billion into sustainable funds globally during the quarter. The US also saw a record quarterly number of 45 fund launches, demonstrating the accelerating interest occurring in the region.[1] At a corporate level, there was record ESG-labelled debt issuance during the year, totalling US $1.079T (+94% y/y).[2]

Fig. 2: Net Zero pledge dates



Source: Energy & Climate Intelligence Unit, 2022.

1 Morningstar, 2022.
2 Morgan Stanley, 2022.

How we integrate ESG into our process

Short-termism and a view that ESG is a separate assessment criterion are both market weaknesses. We believe that ESG criteria should be considered in the same way as traditional financial criteria in terms of their capacity to affect shareholder value and therefore long-term investment performance.

Some ESG criteria are more relevant to certain industries and sectors, and so investors cannot use a one-size-fits-all approach to ESG analysis and integration. Screening and using filters, for example to exclude the highest emitters of greenhouse gases from a portfolio, can serve a useful tool for investment managers. Yet there is no substitute for managers making informed, explicit decisions without an over-reliance on external data.

We look at companies through three lenses: Operational Quality, Competitive Advantages, and Material Issue Management (ESG).

The last of these focuses on those ESG factors we see as most material and pertinent to the successful performance of that business. Rather than applying broad analytics, we prefer to look on a fundamental, bottom-up basis at those factors which, based on our proprietary material issue analysis and scoring, matter most to a business and its stakeholders. An example of how these factors may be analysed on a company-by-company basis is shown in Fig. 3.

The results of this analysis are then integrated into our financial analysis and, ultimately, into the decision to invest – or not – in a business. Including ESG factors in our fundamental analysis not only serves as an excellent risk management tool but, just as importantly, can provide us with opportunities at both a corporate and portfolio management level. We believe that this mindset, combined with our skillset as active managers, is how we can benefit our investors in the long run.

Fig. 3: European Equity Team investment process: Material issue management (ESG)

Category	Luxury goods - Company A	Capital goods - Company B
Leadership and Governance	▪ Board composition ▪ Executive compensation ▪ Management quality ▪ Disclosure	▪ Board composition ▪ Executive compensation ▪ Management quality ▪ Disclosure
Social Capital	▪ Product quality and safely ▪ Data security	▪ Product quality and safety
Human Capital	▪ Labour practices	▪ Employee health and safety
Business model and innovation	▪ Supply chain management ▪ Materials sourcing and efficiency	▪ Product design and Lifecycle management ▪ Materials sourcing & efficiency
Environmental	▪ Water and wastewater management ▪ Energy management	▪ Energy management ▪ GHG Emissions

Changing factors in our ESG risk management research.

Source: RBC Global Asset Management, European Equity team, integrated ESG investment process.

Major ESG portfolio events in 2021

At a corporate level, we were encouraged to see our investee companies continue with their ESG activities. Many are accelerating existing policies and continue to be ahead of the curve in proactively going above and beyond regulatory expectations, and those of consumers.

Schneider Electric

The company was recognised on numerous occasions for its sustainability initiatives. They were given the distinction of being 2021's most sustainable company on Corporate Knight's Global 100 index. 70% of revenues came from sustainable solutions and they directed 73% of investment towards sustainable solutions. They were also recognised as 2021 Microsoft Sustainability Changemaker Partner of the Year for enabling customers to meet their Sustainable Development Goals (SDGs) through their industry-leading digital solutions.[3]

Barratt Developments

The homebuilder announced a multi-million pound investment in Edinburgh. The new development will consist of a mix of social housing and mid-market rent. The addition of high-quality yet affordable housing in the area helps address some of the societal challenges in the community.[4]

Linde

The industrial gas giant announced several partnerships and projects throughout the year that will help many industries reduce their carbon footprint in production. One such project is the building of a two-megawatt electrolyser plant in Austria to supply the semiconductor industry with green hydrogen. The plant will be developed at an Infineon Technologies site, and it will be the first time green hydrogen will be used in their semiconductor manufacturing process. It has the potential to help reduce emissions across the growing semiconductor space.[6]

RELX

The company's legal brand, LexisNexis, launched a sustainable innovation framework, which enables organisations around the world to track and report on innovation's contribution to the SDGs. As part of its PatentSight intellectual property analytics solution, the SDGs are now mapped to the global patent system. This gives companies great insight, leading to better reporting, informed R&D, and enabling more effective investment and evaluation.[5]

Volution

A leader in ventilation solutions, they have formed a partnership with AO to help them move towards their target of having 90% of plastics used in their facilities coming from recycled sources. AO will provide Volution with recycled high-impact polystyrene from around 63,000 old refrigerators annually. Volution in turn will use these plastics to create ducting components in their energy-saving ventilation products. It is a great example of the circular economy in action.[7]

Schroders

The UK asset manager announced the acquisition of Greencoat Capital, one of Europe's largest renewable infrastructure mangers. The acquisition will help bolster Schroder's ESG capabilities. Greencoat Capital will help invest in assets that are at the forefront of the net zero transition. This also helps address the growing demand from institutional investors to allocate capital towards environmentally friendly products.[8]

Information provided for illustration purposes only to demonstrate the investment management process of the investment team and is not a recommendation to buy or sell any security or other financial instrument.

3 https://www.corporateknights.com/leadership/top-company-profile-schneider-electric-leads-decarbonizing-megatrend25289/
4 https://www.wiztopic.com/download-pdf/60e733888aafaa4e5c129d6a
5 https://www.lexisnexis.com/community/pressroom/b/news/posts/lexisnexis-launches-new-sustainable-innovation-measurement-framework-enabling-organizations-globally-to-objectively-track-and-report-on-innovation-s-contribution-to-the-united-nations-sustainable-development-goals
6 https://www.linde.com/news-media/press-releases/2021/linde-to-supply-green-hydrogen-to-the-semiconductor-industry
7 https://www.volutiongroupplc.com/media/press-releases/fridges-fans-volution-help-ao-turns-unwanted-fridges-healthy-fresh-air/
8 https://www.schroders.com/en/media-relations/newsroom/all_news_releases/schroders-to-acquire-a-majority-shareholding-in-greencoat-capital--a-leading-european-renewable-infrastructure-manager/.

2022 outlook: analysing key themes

In our last annual report, we expressed our belief that we were about to enter a new period of acceleration in the ESG movement, with the end of 2020 serving as a quasi-reset. We are pleased to see that this was proved broadly correct, although some of the reasons we posed as to why – namely US political momentum – did not necessarily come to fruition. However, 2021 saw an acceleration in certain areas and we see little reason for this not to continue throughout 2022, even as the world moves into a new inflationary environment and the pandemic hopefully recedes further. The EU Recovery Fund financing has yet to really get going (even if 54 billion EUR in pre-payments have already been disbursed) and as we move forward this should provide continued support within Europe. As 2021 has shown, it is almost impossible to predict how trends may form or dissipate but it seems to us that there are a number of key points that are more likely than others to persist over the next 12 months and beyond.

Zero-washing

Decarbonisation targets at a corporate level are nearing prerequisite levels for the largest listed companies.

The need for every sector to decarbonise has become abundantly clear and, while targets themselves are a welcome addition to company reporting, consumers and investors are starting to require more than just targets; implementation and roadmaps. Much of this has sparked fears of "zero-washing" as companies claim to have net-zero targets and roadmaps, while in reality the ease of setting targets 30 years out in the future stymies shorter-term action.

The importance for short-term goalsetting is partly down to its inherent demonstration of management's realisation of the level of investment required to decarbonise, thereby offsetting significant financial risk in the future. It is estimated that it requires $9.2 trillion in annual average spending on physical assets to attain net zero, far more than the current level today.[9]

The onus will increasingly fall on asset managers to ensure that they are engaging on this with companies at the appropriate level, to ensure that claims of sustainable investing can be justified.

9 Berenberg, 2022.

Regulation, regulation, regulation

2021 saw more than 760 new ESG equity funds launched globally[10], and more than 160 new or revised sustainable finance policy instruments introduced.[11] Europe has long been a leader in sustainable finance policy and this looks set to continue throughout 2022 as a number of headline regulations come meaningfully into play for both corporates and investors. With data disclosure and clarity having long been a concern, the application of these regulations will bring ever-increasing transparency to the market.

Certain elements are of particular interest in 2022:

- The Sustainable Finance Disclosure Regulation (SFDR) is well under way. Article 8 or Article 9 funds already reached 37% of overall EU fund assets in Q3 2021 and it is estimated that this could reach 50% by midway through 2022[13]. As SFDR continues to be rolled out, scrutiny of funds under these labels will increase dramatically.

- The EU Taxonomy, an EU-wide sustainability classification system for activities, saw various activities under climate mitigation and adaptation adopted at the end of 2021. 2022 looks to continue discussion over the EU's decision to include nuclear and natural gas as transitional activities.

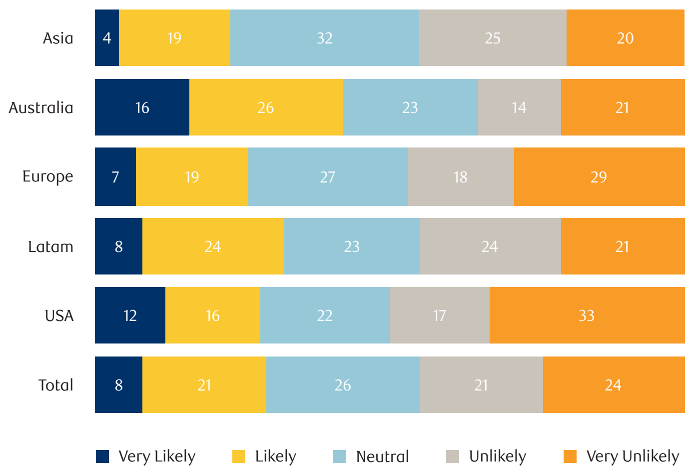
- The EU has also proposed a Social Taxonomy to bring more transparency to investors on the social impact and performance of their investments. The first report is likely to be released during the first half of 2022.

Return to the office

This has been an emerging trend over the last couple of years, but we really see it coming to the forefront in 2022 as the pandemic moves towards becoming endemic. How companies handle the return to workplaces will become a key social issue. Many employees have become comfortable working from home and may not want to return to the office, whether it be from fear of contracting Covid-19, or because they prefer the additional flexibility and freedom that working remotely provides. If employees are forced back into the office for a certain number of days they could leave to join companies that are more remote, or potentially feel like they should be compensated for the inconvenience of commuting to work.

Companies will likely have to balance the benefits of remote work with the impact it could have on company

Fig. 4: Employees (%) likely to switch jobs if work returns to fully in office



Source: McKinsey & Company Reimagine Work: Employee Survey. Data as of April 2021.

culture. It can be difficult to fully experience company culture in an online setting. New joiners, especially those that are new to the workforce, can benefit from in-person training and being immersed in the culture. If these employees are unable to go to the office, interact with colleagues, and build relationships, this could create a lack of motivation to remain with the company. It could be that monetary compensation becomes the only key driver.

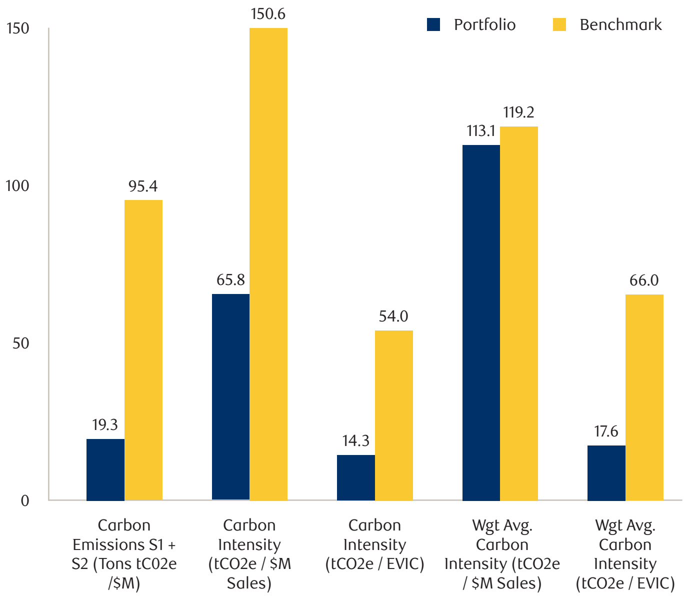
Striking the balance between the benefits of remote work at the expense of benefits from an office environment does not have a universal solution. It will need to be done on a company-by-company basis and even team-by-team within the company to determine what balance is optimal, but it does seem as though some sort of hybrid between home and office is most preferred. The "Great Resignation" has become a common term as employee turnover rates have accelerated.

Companies could continue to experience elevated churn and potentially large increases in labour costs if they mismanage the return to work. According to Oxford Economics, the average cost of replacing an employee (earning £25,000 a year or more) is £30,614, as a result of the logistical costs in recruiting/hiring, but more importantly the costs of lost output while new employees get up to optimal productivity.[14] From an investment standpoint this could start to weigh on margins for companies.

10 BAML, 2022.
11 UNPRI, 2022.
12 BAML, 2022.
13 Morningstar, 2022

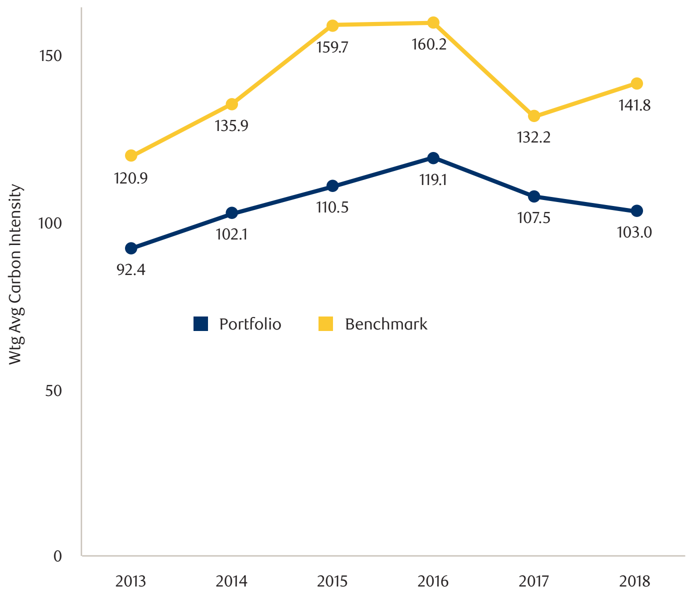
Portfolio ESG analysis

Fig. 5: Carbon footprint analysis (Scopes 1 and 2)



Source: RBC European Equity Strategy vs MSCI Europe. Data provided by MSCI ESG Climate Change Metrics, December 2021, MSCI® and RBC GAM.
*Reflects most recently available data for each company on the date of running the report.

Fig. 6: Weighted average carbon intensity Scope 1 + Scope 2 ($m sales)



Source: RBC European Equity Strategy vs MSCI Europe. Data provided by MSCI ESG Climate Change Metrics, December 2021, MSCI® and RBC GAM.

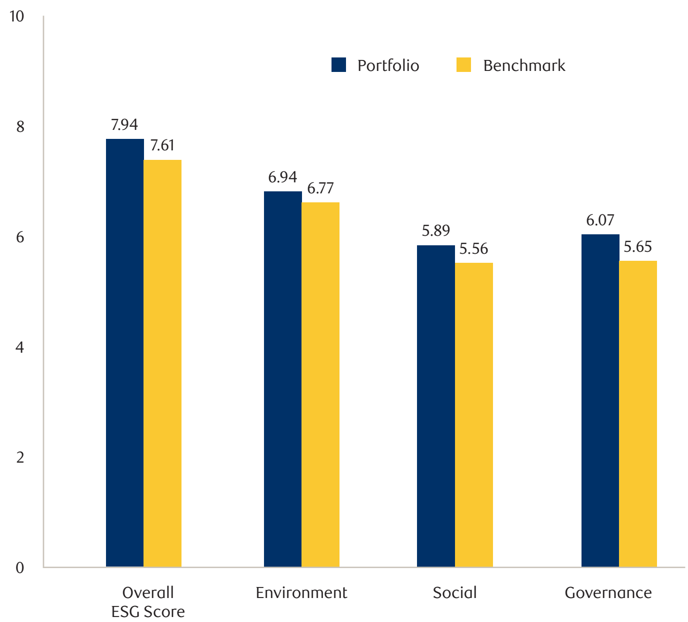
Carbon

Our portfolios continue to exhibit significantly lower carbon intensity than the broader benchmark against a variety of metrics, including by scope, revenue and against sales. While we do not specifically target these metrics, we are cognisant of how the portfolio performs against the wider benchmark.

Relative ESG ratings

With Europe the highest scoring ESG region in the world[15], we are pleased that the portfolio continues to score well on a relative basis. However, we are aware of the limits of external third-party vendor scores so, as with our carbon intensity, we place more value on our fundamental processes.

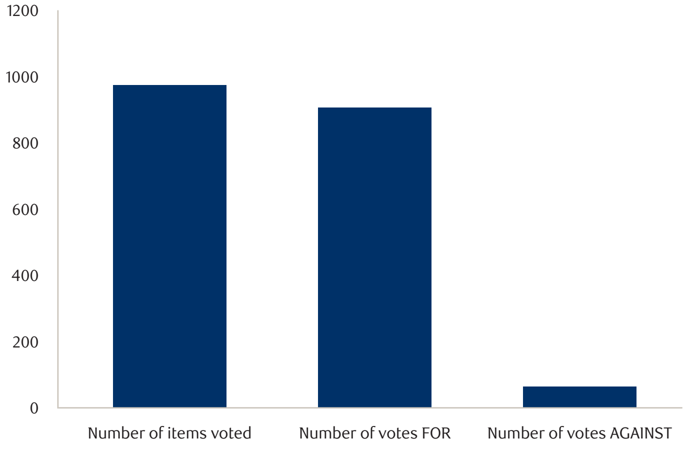
Fig. 7: European Equity Team MSCI ESG Scoring



Source: RBC Global Asset Management, MSCI Data shows the relative scores of the RBC European Equity Strategy versus those of the underlying benchmark, the MSCI Europe Index. Data provided by MSCI ESG Climate Change Metrics, December 2021, MSCI® and RBC GAM.

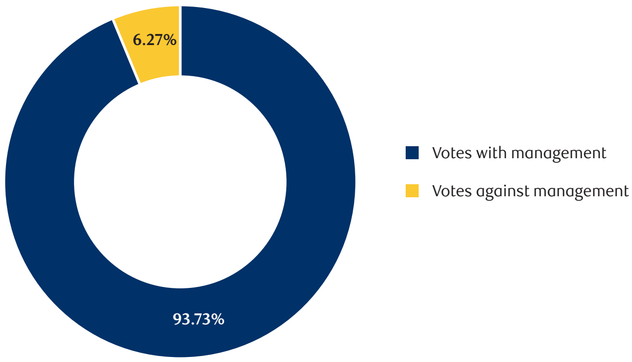
14 http://resources.unum.co.uk/downloads/cost-brain-drain-report.pdf
15 Morningstar, Sustainalytics, December 2021.

Fig. 8: 2021 proxy voting record



Source: RBC Global Asset Management. Data as of December 2021.

Fig. 9: European Equity team votes



Source: RBC European Equity strategy. Data as of December 2021.

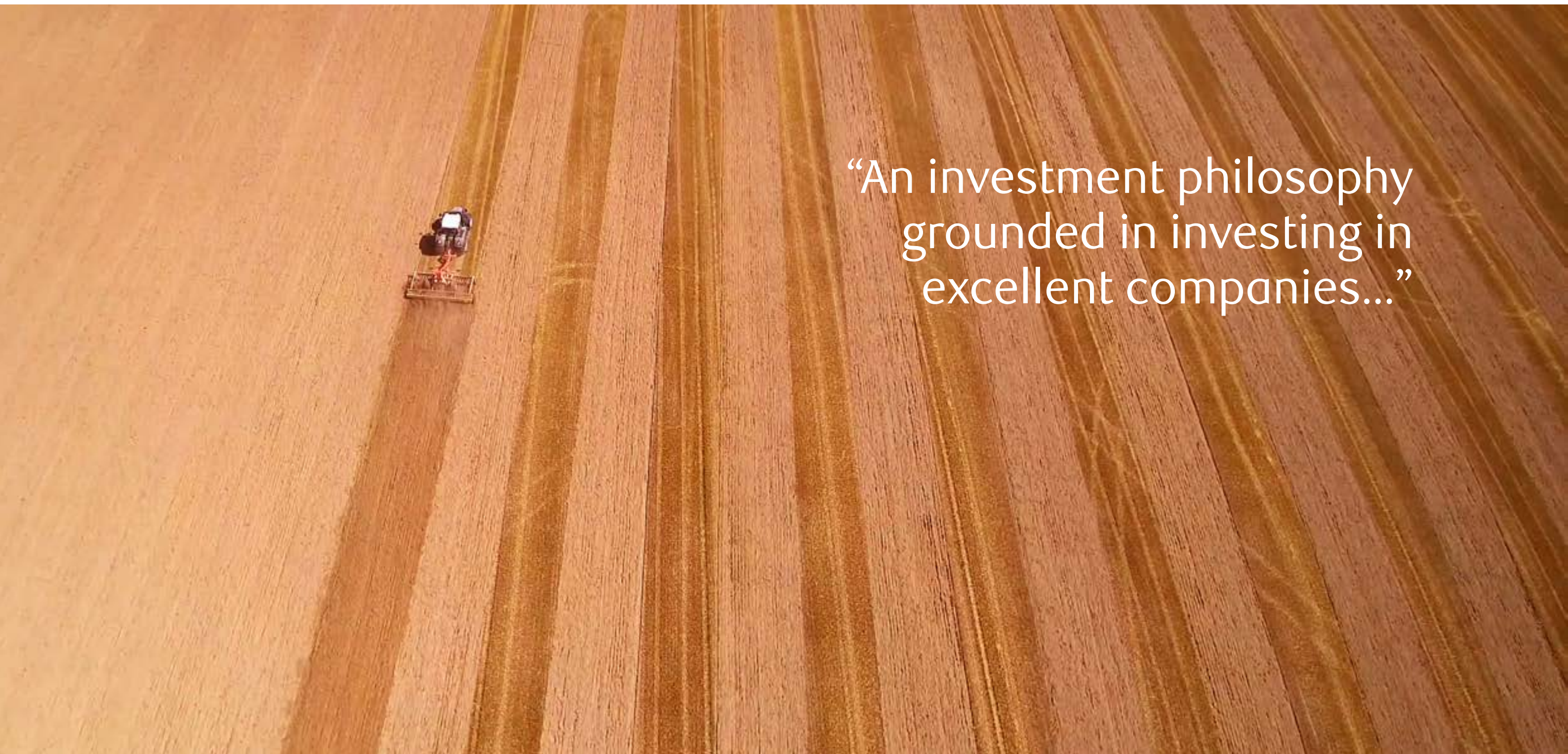
Voting record

Proxy voting remains an important tool for the team in supplementing our engagement with management. While RBC GAM has a set of custom Proxy Voting Guidelines for many markets, in Europe RBC GAM uses the local proxy voting guidelines of a research provider.

The Corporate Governance & Responsible Investment team work closely with the European Equity team to review every ballot item and ensure that proxies are voted in accordance with best practices in corporate governance and in the best interests of our clients. This is with a view to enhancing the long-term value of securities that are held.

The proxy voting process ensures that the European Equity team makes its voting decisions based upon its deep knowledge of the companies that we invest in, while benefiting from the ESG expertise of the Corporate Governance & Responsible Investment team.

In 2021, as in previous years, our percentage of votes in support of management sits at just over 90%. With an investment philosophy grounded in investing in excellent companies, with management teams we both understand and trust to increase the long-term value of the businesses, we would expect this number to remain high. We are, however, always prepared to vote against management when we deem it necessary.



2021: notable corporate engagements

Dometic

The creator of products for outdoor, home and professional use explained to us how they are considering ESG aspects in terms of product development, the suppliers they use, and how they transport goods. For example, their new air-conditioning model is 15% more energy efficient and is also much lighter which helps reduce carbon emissions.

They have monthly reviews of their ESG initiatives and targets, but plan to be more explicit to the public. They believe sustainability is becoming a more important issue when trying to attract talent to the business as people want to work for companies making a positive impact, and management incentive programs now include ESG targets.

Kerry Group

The CEO of this taste and nutrition company outlined how their business proposition enables their customers to deliver on their sustainability promises, particularly small and medium-size firms. Kerry's technologies can help customers achieve "clean labelling" - a term used by the food industry to describe consumer-friendly labels and trustworthy natural products. They have also been facilitating the move to plant-based protein alternatives in an effort to make food sourcing more sustainable. The company is now incorporating sustainability goals into the long-term incentive plans of management.

Sika

Management explained to us how innovation is key for brand quality and market share gains at this specialty chemical company that develops and produces systems and products for bonding, sealing, damping, reinforcing, and protecting. Some 25% of sales are from new innovations with sustainability being the most important part of innovation. Their applications help customers reduce their carbon footprint and there is receptiveness for these solutions from construction companies and building owners.

Given their quality and reliability, Sika are an obvious choice for customers. They hold Cradle to Cradle Silver Certification for their thermoplastic roofing membrane technology – showing they meet a global standard for products that are safe, circular and responsibly made.

Ashtead

We discussed how the industrial equipment rental company manages employee health and safety and relations with the workforce. They explained how safety is at the forefront of everything they do, and not only do they ensure employees have appropriate training for all of their equipment, but they also ensure customers have sufficient training as well.

The company explained how it is a difficult environment to attract and retain talent so they have been proactive in raising wages, but have also placed emphasis on benefits such as health insurance.

Marel

Management at this food processing solutions company explained how sustainability is becoming a top three key concern for customers, with considerations on using fewer resources as well as better traceability. Their efficient machinery helps customers have a lower impact on the environment. The technology and software they provide with it has more traceability and eases the reporting for Task Force on Climate-Related Financial Disclosures (TCFD). We also discussed the company's own TCFD commitments and 2030 targets and how they are reducing their impact on the climate through localising teams to reduce travel and using renewable energy within their own operations.

Homeserve

We discussed how the home emergency repairs and improvements business manages cybersecurity risk with more of the business moving online. They have put a structure in place where all systems that they operate have a data protection overseer and then one who oversees the whole group. They did a large mapping project for GDPR and how they use and access all the data they obtain. They also have a centralised systems officer with localised leaders to manage cybersecurity risks and processes. They are using AI to track all transactions to determine if anything looks suspicious.

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Our recent ESG research and articles

COP26 review

The team were delighted to welcome Ben Yeoh of the RBC Global Equity team to discuss his views on COP26 and what his key takeaways were. There was a timely reminder, given the media pressure and hyperbole, that COP is a yearly event and as such it is sometimes forgotten that each event is supposed to demonstrate incremental progress rather than a single world-changing event. On this basis, the continued progress towards limiting global warming to a lower temperature was seen as a small positive, even if hopes had been firmly placed upon setting targets to reach 1.5°C.

The age-old debate of where responsibility lies between policymakers, citizens, and corporations has seen far more onus on companies to take action with regard to the environment, driven in part by popular opinion. We discussed how this was now shifting on to investors, with an increasing focus on how stewards of capital should engage and influence companies when it comes to ESG matters.

Listen to the podcast here

Technology and energy consumption

Digitisation is accelerating, from Bitcoin to 5G, but do we fully understand the environmental impact of these technologies?

To look at this question, we released a podcast to discuss the nuances behind digital technologies' relationship with energy and decarbonisation and show that, just because something is digital, does not mean it is carbon neutral.

2021 saw the energy consumption of Bitcoin come under the microscope, leading to Bitcoin mining bans in some countries. This energy intensity extends beyond mining alone as computing uses vast amounts of energy. The digital economy uses almost 10% of the world's electricity, far more than airlines at present. If the tech sector was a country, then it would be the 5th biggest emitter.

It could seem that technology cannot align with decarbonisation. However, a lot of research seems to suggest that, while technological innovation may lead to increased energy consumption in the short to medium term, it can ultimately result in a reduction in energy consumption in the long run. Ultimately, technological innovation allows for far lower unit costs of what is arguably the most valuable commodity of today: data.

Listen to the podcast here

Decarbonisation part 2: techno-optimism or necessity?

In a recent interview, John Kerry, now the United States' Special Presidential Envoy for Climate, stated that he was "told by scientists that 50% of the reductions we have to make (to get to near zero emissions) by 2050 or 2045 are going to come from technologies we don't yet have". This statement led various factions of the decarbonisation movement to furiously debate the merits of what some parties deem to be damaging techno-optimism, and others deem mathematical necessity.

The debate over novel - mitigating or adaptive - technologies in the fight against climate change is probably misunderstood. One view is that projected technologies will be used as an excuse not to change existing, destructive human behaviour. The other view is that a lack of development will ensure that net zero remains forever out of reach. To our mind the answer lies somewhere in the middle, and this is an opinion shared by the International Energy Association and many governments and NGOs. Progress will need to be made on both sides of the argument to successfully decarbonise the world's economies. We looked at how well established companies of today are exploring and investing in emerging technology that may shape the future of decarbonisation and how investors can gain exposure.

Read more here

Climate Wars: implications for countries and corporates

Following the release of the IPCC's Climate change assessment report in August 2021, we examined how their stark warnings could have implications for both countries and companies. The report emphasises the huge financial requirements needed to make the necessary progress.

It is now estimated that the economic impact of climate change will reach $69 trillion this century, with energy transition investment therefore needing to rise to $4 trillion a year. We can look at the last few decades as a series of fronts - east vs west, developed vs emerging – and view climate change as a new frontier over which different countries or regions will battle.

Currently, the US and China seem to be fighting over future Green supremacy, including control of supply chains and rare earth production, as well as a political front with both countries attempting to influence other countries through diplomacy and green finance. At a corporate level, there may have been a watershed moment in May 2021 as a Dutch court ruled that Royal Dutch Shell needed to cut its greenhouse gas emissions by 45% by 2030, compared with 2019 levels. This raises intriguing questions as to how individual companies are going to navigate this new world.

Listen to the podcast here

Conclusion

We believe that ESG will continue to permeate areas of the investment, regulatory and corporate landscapes for the foreseeable future, often in surprising ways. Themes will wax and wane, but we stand firm in our belief that investing in the best companies that pay attention to the fundamentals of ESG will continue to provide robust returns for investors.

In the meantime, we continue to assess and evolve our own views and processes to ensure that we can be as far ahead of the curve as possible on behalf of our clients.

About the authors

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Freddie is a Product Specialist on the RBC European Equity team at RBC GAM. Prior to joining the organisation in 2018, Freddie was Head of Investment Oversight for the London local authorities' collective investment vehicle. In that role, he helped to oversee the pooling and management of up to £35 billion of pension strategy assets, with a focus on investment analysis, manager selection and oversight. He spent the preceding few years assisting with the creation of the underlying investment management company, guiding it from concept to launch. He also previously worked for a large British multinational investment bank in London. Diploma in Investment Management (ESG) (2020); IMC (2013); BA (English Literature and Language) (2012), University of Leeds, UK.

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