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Capital Management Group

News

A 'Responsible Transition' approach to Investing

We know the goal, the challenge is to manage urgent change effectively. How can investors accelerate the transformation?

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Decarbonisation has become a nearly universally accepted priority. Everywhere, companies are having to respond to direct legal and regulatory requirements and incentives, along with softer forms of pressure from customers, shareholders and employees. It is our expectation that companies that are making important contributions to this mission will be rewarded and that investors need to be on the right side of this structural trend.

There is a risk, however, of oversimplifying the analysis. The modern industrial world cannot simply halt all carbon-dependent activity. While opinions will vary widely on this topic, even investors who are keenly concerned about reducing emissions should not, in our view, automatically boycott carbon-intensive businesses. We are arguably already witnessing some of the risks associated with making too abrupt a shift in the name of environmental goals, such as Germany' abandonment of nuclear energy.

European dependence on Russian gas supplies has contributed to a situation now where coal and diesel are being relied upon as fallback fuels.
Skyrocketing energy costs not only threaten the ability of European and other countries to make the massive investments required to develop a low-to-zero carbon infrastructure, but they also threaten to undermine public support for the goal. There is presumably a limit to which voters will tolerate a reduced standard of living to achieve hard-to-define long-term carbon objectives. Without popular support, it is hard to imagine the decarbonisation agenda having staying power.

The current energy crisis serves as a reminder that, notwithstanding the relationship between fossil fuels and climate change, the world needs energy to function. There are real consequences when access to energy is interrupted or becomes very expensive. Ironically, Energy Transition is itself an energy intensive endeavor and requires abundant energy to progress at the near-term pace we need. For investors, we believe this is a moment for realism on the journey towards a low carbon future.

Our view of Responsible Transition

As the world becomes more pragmatic about achieving our collective carbon objectives, companies that help to move the ball forward may include, possibly counter-intuitively, those that are involved in the production or distribution of fossil fuels, or that consume fossil fuels directly or enable the use of fossil fuels. We believe these companies may be among the most important in terms of getting the world to a lower carbon future. We offer a number of examples below, across different industries.

Industrials

Headquartered in Ireland, CRH PLC is among the largest building materials suppliers in the world, with a significant presence in carbon-intensive areas like cement production. Cement, the glue that binds concrete together, is an essential building material with few practical replacements. If we want to live in a world that has houses, apartment buildings, bridges, roads, airports, tunnels, hospitals and schools, we need cement. But the process of forming cement, unfortunately, involves significant carbon emissions. The process is energy intensive (temperatures as high as 1450 degrees Celsius are needed) and the chemical reaction of converting raw materials like limestone into clinker (which is then ground down to form cement powder) involves a substantial release of CO_2. CRH' other activities —mining quarries, road paving, manufacturing architectural products, distribution—are also energy-intensive.

Given the carbon-intensive nature of its business, some investors may choose to avoid CRH. We would argue that this is an untenable position unless one is prepared to forego almost all the benefits of modern (if not pre-modern) civilisation. A better approach is to invest with sustainability leaders in the building materials industry, companies able and motivated to drive through the innovations needed to produce essential goods through a much lower carbon output.

As one of the larger public companies in what is a relatively fragmented industry, with many smaller firms privately held, CRH has the scale and management sophistication to lead the industry. The company aspires to be carbon-neutral along the cement and concrete value chain by 2050, through limiting fossil fuel use and repurposing waste materials. CRH has committed to a 25% absolute reduction in Scope 1 and Scope 2 CO_2 emissions by 2030.

Increasing pressure to reduce emissions is likely to give companies such as CRH an edge over smaller, less advanced players who may struggle to deliver on the expectations of their stakeholders. As a leader in a sector that has major sustainability challenges, CRH arguably enjoys structural advantages versus peers that may ultimately translate into value creation for shareholders.

Utilities

Terna is a regulated utility which owns the vast majority of Italy' high voltage electricity transmission network. Terna' assets are essentially the backbone of the electrical grid in Italy, connecting sources of power generation with distributors who extend power lines to homes and businesses. Transmission networks are historically a mundane piece of energy infrastructure, with bond-like attributes from an investment perspective. Returns are typically regulated and grow slowly with replacement and expansion of the asset base. The current environment has altered the script, however, particularly in Italy. The transmission network is now a vital part of Europe' transition from carbon-based fuels to power the electric grid towards renewables like wind and solar. With Russia' invasion of Ukraine, this transition is only more urgent. Italy historically imports some 40% of its natural gas from Russia and relies on natural gas for close to half of its electricity generation.

Terna is now playing a major role in allowing Italy to convert from fossil fuels to renewables to power the electric grid. Substantial investments are required to reconfigure the network and connect high voltage output from onshore and offshore wind projects as well as solar. Expansion of the electric grid is also required to accommodate the evolving transition from internal combustion toward electric vehicles.

Energy

The Williams Companies is one of the leading energy infrastructure companies in the United States. Williams handles approximately 30% of all natural gas used in the US through its ownership of interstate pipelines along with gathering and processing operations throughout the country. Among midstream operators, Williams has emerged as a sustainability leader. We believe Williams is a good example of responsible transition because of the superiority of natural gas relative to other fossil fuels, as well as the company' commitment to reducing emissions in other ways.

It is widely accepted that the transition from coal to natural gas as a fuel for electric power generation has played a crucial role in reducing US greenhouse gas emissions, which have been declining since 2005. According to the EPA, “The decline in recent years is due to an increasing shift to use of less CO2-intensive natural gas for generating electricity and a rapid increase in the use of renewable energy in the electric power sector.”

Burning natural gas generates about half as much carbon emissions as burning coal per unit of heat created. In an ideal world, we would not require any fossil fuels to meet our energy needs, but a more immediate priority is ending coal use, while renewable technologies advance. It is also imperative to have affordable electricity as we seek to transition the automotive fleet towards electric vehicles. Without abundant natural gas, the economics of EV ownership from a consumer perspective would be significantly less attractive.

Williams has emerged as a sustainability innovation leader within the oil and gas industry and is involved in a number of promising initiatives. In 2020, Williams announced a climate commitment to achieve a 56% absolute reduction in company-wide greenhouse gas (GHG) emissions by 2030, with a goal of net-zero carbon emissions by 2050. Renewable natural gas involves the collection of methane from organic waste sites that would otherwise enter the atmosphere. Another project is Clean Hydrogen Future Coalition, which studies the impact of blending hydrogen with natural gas in its pipeline infrastructure. Carbon capture and storage is also a priority for Williams, which currently runs a processing plant in Colorado that captures carbon for industrial chemical production, while they also evaluate further utilisation and storage possibilities in other parts of the network.

A realistic approach to decarbonisation

Opinions will vary widely as to private sector approaches to the carbon emissions challenge. We believe companies that can contribute meaningfully to GHG reductions will win in the marketplace. A purist approach to sustainability leaves industry players who are leaders in this area in the same bucket as those who are far behind. From an investment and broader social perspective, we believe the focus should be on differentiating the stronger actors from the weaker ones.

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