

# An investor's guide to climate collaboration

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This handbook explains how sector-wide engagement can lead to dramatic and rapid changes in Real Assets investments.

Van Lanschot Kempenn Investment Management (VLK Investment Management) has been practising responsible investment strategies for decades, including smart corporate engagement and delivering change through shareholder action. But we would like to share our experiences and expertise and offer a 'short cut' to peers so we can work effectively together.

That's what this guide is all about.

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## Introduction

Institutional investors managing at least USD\$10trillion now practise active ownership across global markets.<sup>1</sup>

But acting as a responsible steward on climate risk – the key issue for our generation – is far from straightforward. In the world of investment it can take years to facilitate effective behaviour change in laggard companies. This is time we no longer have. “We need to go far, quickly” as former US Vice President Al Gore says.

Action by individual companies is not enough. All companies in all industries must do their part to decarbonise and address our shared, urgent issue. One company may be streaks ahead, but this in itself does not mean it is protected from climate risks, and the long-term success of our portfolios – and our planet – depends on sector-wide improvements. As active investors, we have a responsibility to use our power to drive forward change through our control of capital.

What we seek to offer with this handbook is an explanation around how to perform sector-wide engagement that leads to dramatic and rapid change in Real Assets – one of the biggest contributors to global climate change. That can and must be our shared goal to mitigate the catastrophic effects of our climate emergency.

1 [GSI Alliance, 2019](#)

# 1 Why sector-wide engagement in Real Assets is key to reaching zero

To paraphrase Bill Gates in his recent book *How to Avoid a Climate Disaster*, there are two numbers that investors in the Real Assets sector need to know when it comes to climate change.

The first is 20 billion – the approximate measure of tons of CO<sub>2</sub> per year that the sector currently emits – and the other is zero. Zero is our goal for global greenhouse gas emissions. Zero is also the number of tons the sector must emit by 2050.

We say ‘our’ goal because it is ours collectively. As active investors we must commit ourselves to reducing global greenhouse gas emissions where we can. The Real Assets universe comprises of infrastructure, utilities and real estate, which together are massive contributors to GHG emissions, in many cases upwards of 40% across portfolios.<sup>2</sup> As investors, we have two choices:

1. **Avoid investing** – we sell off companies to reduce our portfolios’ reported CO<sub>2</sub> footprints, and assume someone else will solve our problems.
2. **The ‘Real Active’ approach** – we engage powerfully with investee companies for improvement, creating the change we require rather than waiting for it to happen.

The latter approach may result in portfolios with higher CO<sub>2</sub> footprints in the short term, but our goal is not to tick a box to meet an arbitrary target in a fixed time period. Our goal is to get to zero global greenhouse gas emissions. Given the scope of the challenge we’re facing, a broader approach than simply one-on-one company engagement should be considered. Partnerships between asset owners in common engagements reinforce the message, and pack a heavier punch for greater impact.

Moreover, developing a partnership mindset among the companies we are in dialogue with helps the cause too, since it reinforces the fact that we are all on the same journey together.

<sup>2</sup> Sources of GHG Emissions, EPA

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We seek to develop a partnership mindset among the companies we engage with. It reinforces the fact that we are on the same journey together.

This Handbook is designed to strengthen this approach even further. We intend to demonstrate how to engage with the sector as a whole: the laggards, the leaders, the companies we own, and those we may invest in in the future.

## Sector-wide engagement

To meet the goals of the Paris Climate Agreement, both utilities and the real estate sectors need to decarbonise rapidly, given their material CO<sub>2</sub> footprints today. At the risk of oversimplification, utilities will need to accelerate a reduction in their CO<sub>2</sub> footprints by changing their power generation mix towards a lower carbon energy mix, whilst for real estate, the challenge is twofold involving reductions in emissions during construction, and operational emissions thereafter.

## When to engage and when to walk away

Where a potential investment is not on a Paris-aligned trajectory and we see an alpha opportunity, we will engage for change. Often, this happens ahead of the first capital being deployed.

If there is no willingness or intention to change, we will NOT be investing. We 100% believe in selling the full position of these companies, as opposed to selling back to the benchmark position. This differs in two ways from divesting, which is a more widely publicised tool in our industry.

## Sell everything vs. Divesting

Selling everything is under the radar. It garners less publicity, and leaves the door open to changing positions should the company's behaviour change. Divesting from an industry with high CO<sub>2</sub>e emissions is assuming all participants in that industry are the same.

Bottom-up investors who know their stocks know this is not the case. There will be companies in that industry who are participating aggressively in the energy transition vs. those who are not moving, or moving too slowly.

In this regard, selling fully is a more intelligent form or withholding capital than a blanket divestment approach.

As simple as this sounds, the challenge for equity investors in the current era is to create real world change as well as profit, and it is as complex as it is serious. We cannot rely on a handful of companies to make the necessary changes – **the scale we need requires sector-wide action.**

Engagement must be expansive and deliberate, and not solely focused on a few big names that fall into a portfolio. This broader approach recognises that the whole system needs to change, and the sector at large must be fit for purpose in a low carbon economy.

Failing to take a sector-wide approach has the unintended consequence of pushing one company to change in its sector (that is, setting its own bar higher) but without addressing the implications for profitability in a competitive landscape.

As active investors we strive to better understand the challenges a company faces before we make a call for action via an engagement. During this journey, if we can understand how one company moves along the energy transition pathway, we can consider how replicable those steps are for the industry at large. Sometimes we may discover or encourage opportunities for positive-contagion of best practices from one member of an industry to another.

## Why Real Assets?

Real Assets, especially utilities infrastructure and real estate, have a critical role to play in facilitating the transition towards a greener economy. For investors, Real Assets provide attractive and predictable cashflows, and for economies and society more broadly, they provide the physical backbone for growth. But at what cost?

One of the United Nations' Sustainable Development Goals is specifically to develop industry, innovation and infrastructure, and many of the others rely on Real Assets investments in order to advance towards a sustainable, equitable future for us all. From affordable and clean energy, to building sustainable cities and communities, significant investment is required and it is our responsibility to direct capital flows towards projects which have a demonstrably positive ESG impact.

As active investors, we are able to exert our influence and ensure that companies incorporate ESG criteria in any sector. But a question must be asked where we can have the most significant impact. Some investments outside of Real Assets, such as a portfolio containing high-performing technology companies, are already cooking into their business models innovative ways to contribute to a more sustainable society and a greener world. But why commit large amounts of time and energy to shaving off small quantities of emissions from these companies, which are likely already moving towards having a net positive impact?

In the VLK Investment Management investment universe, Real Assets are responsible for up to 42% of all emissions across our investments. Herein lies the opportunity. By actively engaging with some of our 'dirtiest' investee companies, our engagements can have a greater impact, sooner.

## Engagement halts release of one billion tons of CO<sub>2</sub> emissions

With assets in Hong Kong, Australia and China, CLP is a Hong Kong listed Power Generation and Distribution company. In fact, it's the second largest Hong Kong listed utility in our Listed Infrastructure benchmark.

The company generates 51% of its power from coal, but intends to close these plants down over time to align with the Paris Agreement. However, they were also considering the building of two new coal plants in Vietnam.

Based on our estimations these would emit around 1 billion tonnes of CO<sub>2</sub> over their lifetimes (= coal plant CO<sub>2</sub> emissions x capacity x lifetime). It is our strong belief that stopping these projects is much better aligned towards the goals of the Paris Agreement.

Having spoken to the company about alternatives to the project, such as strengthening their current renewables investments, we sought to have these projects cancelled. We also presented the option of returning cash to shareholders that would have gone on the coal projects.

To increase the probability of success, we explained to the company that on our analysis the company could see a positive re-rating from investing in a way that signals they are aligned with the expectations of the Energy Transition.

In December 2019, the company announced that no new plants would be built. Beyond what we asked for, the company also committed to strengthening its Climate Vision 2050 targets every 5 years. We then updated the forward looking ESG score we apply to this company, and closed out the engagement.

## 2 Achieving zero: how to engage effectively on climate

### Understanding the complexities

The overall goal of the energy transition is that the CO<sub>2</sub> footprint of the planet is reduced. However, this process may be counterintuitive, in the examples that a falling CO<sub>2</sub> footprint for a portfolio does not mean reduced CO<sub>2</sub> emissions globally. And vice versa, a portfolio with a rising CO<sub>2</sub> footprint does not individually increase global CO<sub>2</sub> emissions.

At the investment level, an energy company that innovates to enable overall decarbonisation may see their own CO<sub>2</sub> footprint increase in the short term but reducing the planet's CO<sub>2</sub> footprint in the longer term. We do not believe that this should be penalised.

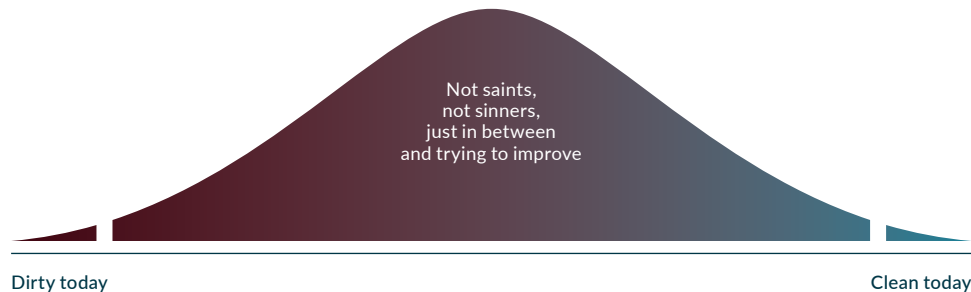
Following from this, it is tremendously important to consider companies' CO<sub>2</sub> trajectory. Judging stocks in a binary framework of clean vs. dirty misses the overall journey and potential long term improvements, and fails to reward this appropriately. This framework also leads to box ticking exercises as it judges a company at a certain moment in time with little thought to its longer term objectives or climate requirements.

As such, we suspect that very few companies are truly villains or saints, and most will be sit in a grey area in between, therefore requiring deeper investigation (see Fig. below).

Another complexity is that – particularly for utilities infrastructure – the impact of moving from 'dirty' to 'clean' may be another false binary. The reality is that in many cases, companies will realistically only be able to move from 'dirty' to 'less dirty,' at least for now. From a portfolio perspective, this needs to be recognised and encouraged because currently it might be the best available option.

There should also be due consideration around the mindset of the company. Are they on board with target setting? If they are setting tangible targets, are they in fact credible? Sometimes objectives may be arbitrary to satisfy investors and other stakeholders in the short term, so it is important to correctly asses which way the wind is blowing within the company itself.

Lastly, there may be conflicts within the ESG goals of both investors and the investee companies. The investor may care deeply about the environmental factors of the business – such as a massive reduction in CO<sub>2</sub> from closing down a coal power plant. Conversely, the company may care equally deeply about ESG but with a focus on the social element. They may employ hundreds of workers at the same coal plant, who would stand to lose their jobs. In reality, this particular example may not lead to a just transition as those former coal plant workers could face long-term unemployment if they could not, for example, retrain for the digital economy.



### Our milestone methodology

When we engage for change at VLK Investment Management we define and track the success of an engagement against a set of four milestones:

#### ➤ Milestone 1

##### Raise concern

The investor identifies the issues and brings it to the attention of the relevant board members or management team of a company

#### ➤ Milestone 2

##### Company acknowledgement

The company acknowledges the importance of the issue raised to the company or its stakeholders and commits to resolving the issue

#### ➤ Milestone 3

##### Company policy

Company has developed or improved its policy to deal with the specific issue

#### ➤ Milestone 4

##### Company implements programme

The engagement is closed when the company can provide clear evidence that the policy or strategy is fully implemented and that there is clear accountability from the top.

### Evaluating what's said, done, and how

It is encouraging that that levels of reporting and voluntary disclosure have risen in recent years. External organisations like CDP, which runs the world's environmental disclosure platform, count over 10,000 corporates providing environmental data, and this number continues to grow. However, when it comes to internal reporting there are still issues and cynical number crunching that needs to be addressed.

When it comes to reporting and disclosure by one company it is seldom comparing apples with apples with another. For emissions tracking, some differences that must be reconciled are outlined below.

### Different starting points

An example may be that Company X sets a starting point for its emissions data tracking at 2005, and sets a target to bring down its overall emissions by 50% compared to 2005 levels. Company Y meanwhile might have a much shorter timeframe, making them difficult to compare. Company Z sets its starting point cynically at its worst ever year for emissions, meaning that making reductions needn't be so dramatic, in comparison to its annus horribilis.

### Different scope of investigation

In Real Assets, we advise that CO<sub>2</sub> intensity should be measured for ALL assets. In an ideal world, this means taking Scope 1 (all direct), Scope 2 (indirect) and Scope 3 (all other indirect) emissions together, and setting reductions targets from this data. This is both possible and recommended for utilities, but for Real Estate Scope 3 emissions are not usually as integral to the physical asset as they are for infrastructure, so many companies do not track them as effectively.

### Different decarbonisation pathways

Say a company sets a realistic emissions reduction target within a realistic time horizon. It may be that a decarbonisation pathway of 70% is achievable, and looks impressive. However, our analysis of companies sometimes find that 80% could be achieved too, and that more ambition is needed.

## 6. Asking the right questions in the right places

Before any engagement begins, we need to discover the degree of freedom a company will have to make good on their commitments. For example, how much control do they have over their operations, or how dependent are they on third parties? Further, what regulatory requirements are applicable to them? Once the right questions have been asked and answers established, we can then start to assess the willingness to move within those bounds.

Sometimes the process may then require us to redirect our engagements beyond the companies themselves. This may mean engaging other stakeholders such as regulators to increase the degree of freedom in which the company can operate. For example, it may be the case that regulators are not compensating utilities for earlier closures of coal plants.

Collaboration is also a key part of this process. We aim to collaborate with companies who find themselves in the grey area but have the ambition and means to move the dial towards becoming cleaner, helping them demonstrate their improvements and rewarding them appropriately. But collaboration must also be among like-minded investors – by working together, we wield a much greater power to make our voices heard, and subsequently have an impact through our combined clout. To help foster understanding between investors, we have developed the following questions in line with current European sustainability taxonomies.

This broad stroke list of questions is expected to be refined over time, though for now is designed to get investors like us asking the right questions of our investee companies and drive the low-carbon transition.



# 3 Sector-wide engagement – the questions to ask

A 'cut-out-and-keep' guide to the questions investors should be asking investee companies to drive the low-carbon transition:



## The present day

- To what extent are GHG emissions measured, by scope, and externally verified?
- Which emissions are not measured, and why?



## Target Setting

- Do you have a net zero emissions commitment? If not, what considerations are being made around this?
- If a target has been set, how was base year decided?
- How were your targets set? Do you have both interim milestones and a final goal?
- Are your targets Paris-aligned?
- What will be the impact of meeting these targets on your GHG footprint?



## Strategy & Capital alignment

- Which strategic steps will deliver these GHG reductions?
- How much will each step contribute?
- To what extent are you relying on offsets to meet your targets?
- How were considerations of a just transition (i.e. considering social impacts) incorporated into this strategy?
- How much of future capex is aligned to GHG reductions?
- Can targets be met with current technology, or are you relying on new innovations to help?



## Ambition levels - willingness vs. ability

- What obstacles were there to setting this goal?
- What incentives were there to setting this goal?
- What obstacles are there to doing more?
- What incentives are there to doing more?



## Commitment - understanding incentives

- How are the inputs to these goals reflected in annual bonuses?
- How are the outcomes reflected in the longer-term incentives?



## Reporting & Evaluation

- How often do you report on milestones being met?
- How often is the decarbonization strategy reviewed and evaluated?
- Is reporting in line with TCFD recommendations?

## 4 Engagement for impact

By asking the right questions of investee companies there is considerable scope for success in both the short and longer term when it comes to driving down emissions. However, it is rare that that headline actions – “Energy companies closes all fossil fuel plants,” or “Real Estate association becomes net positive” – are instantaneous decisions which impact emissions.

Instead, approaches are more gradual and often require years of incremental work to reach the headline actions. This is where smart engagement, and asking the right questions, comes in. VLK Investment Management has seen some success here as a standalone investor, and we are constantly seeking to quantify the impact so far by pushing for transparency among companies, and standardising these classifications so we can compare companies like for like. This means ensuring that reporting is done with TCFD in mind, for example, or ensuring that the climate issue is addressed in all capex considerations and strategies are aligned towards Paris.

All that being said, realistically we know that greater power comes from pooling our resources as investors. That is, joining up with other investors to pack a heavier punch, and working with a partnership mentality in mind in line with SDG17. We try to ensure that the investee companies also join this partnership mentality, in order to increase dialogue with regulators and peers who share similar goals.

### Smarter questions for Fortis Energy

This US energy provider Fortis could claim an 80% reduction in GHG emissions compared to 2005 levels, as it makes moves to close one coal power plant within two years, and another shortly thereafter. Our engagement started by asking questions around how they decided the base year, and resultingly were able to discover so much more.

It turns out that Fortis Energy, for all of its goodwill and commitment, cannot close the other coal power plant down because the renewables grid in that area is fragile and prohibitive, and cables do not bring power from other areas which have a more reliable renewables infrastructure.

Due to these circumstances the regulator will not allow the company to close that coal plant for the coming decade at least. Therefore, how quickly it can close and Fortis can meet its targets depends on infrastructure improvements which will enable energy transport from other states as a backup.

Where a simplistic, binary investor approach will see the coal plant remaining open as a negative, our deeper engagement and questioning has enabled something more positive. Fortis will now use the remaining plant only as a backup in winter, meaning that its use will go from 85% to 20% in two years and stay at that level until better infrastructure is built and it can close down once and for all.

Part of our engagement is also with the regulator, to establish what incentives they have to encourage better interconnectivity.

This more intelligent approach to engagement will see improvements both in the short term before the second plant closes, and in the long term when it does.

## 5 Conclusion

The climate challenge is a call to action for all economic and societal participants, and the finance sector has a choice in how large a role it chooses to play.

The opportunity for us as the allocators of capital is massive, but the sector needs to step to its fullest potential.

Our approach at VLK Investment Management has been ten years in the making, but at this juncture we are only certain of two things – our approach is not perfect and it will see reiterations over time, and most important we can and will not achieve the desired results from the Paris Climate Agreement on our own.

In the spirit of the latter, we hope this handbook provides some food for thought, showing transparently the path that we are taking. We invite you to join us.

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Ultimately, we therefore argue that a co-engagement approach is the right way forward. Even though asset managers may ‘compete’ in the marketplace, we also share a common cause and invite our peers to join us.

## Contact

If you have any questions please contact us or visit [vanlanschotkempen.com/investment-management](https://vanlanschotkempen.com/investment-management)



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