Embracing Future Through Sustainable Investing

All talk about ESG (Environment, Social, Governance), but what it actually means?

ESG investing has become one of the exciting trends racing the global market. ESG can no longer be categorized as the future of investing – It is a reality today!

Issues such as climate change, cybersecurity, data protection, workplace diversity & inclusion, and better stakeholder alignment are now widely accepted. While the definition of ESG differs, understanding why ESG is here to stay is imperative.

ESG considerations represent material economic information that help explain companies' future beyond what can be deciphered from a financial statement. Today, this might look less important to investors, but these risks can manifest in future.

Whilst 2020 may go down in history as major year for global pandemic, it did create some other eye-catching records, especially in the field of sustainable finance. Globally, over the previous 5 years, ESG equity funds have seen cumulative inflows of over $313 billion since 2015 while non-ESG active equity funds have seen cumulative outflows of $2.7 trillion. (Source: EPFR Monthly Data, Bernstein analysis)

What caused this acceleration?

Borrowing from Victor Hugo's quote "No force on earth can stop an idea whose time has come"; we believe that ESG is one such concept whose time has come. ESG investing became prominent 4-5 decades ago as the world witnessed damaging events – use of chemical weapons during the Vietnam War, global anti-apartheid movement, Chernobyl accident and the oil spill in Alaska. These events triggered the need of an important sensitivity to be incorporated in the journey that the new generation would undertake.

In present context, we believe there is not one but confluence of many reasons which can be assigned to explain the increasing shift towards ESG practices. For instance, COVID-19 spread which is bringing to the forefront the importance of social practices, and temperatures rising around the world which is raising relevance of damaging environment conditions..

Past couple of years has accelerated a trend in ESG which is here to stay and may cause significant changes in business and investment landscape. These trends have potential to disrupt existing industries as well as create strong opportunities in new areas. So, let's briefly look at some of the evolving trends in elements of ESG.

The evolving E in ESG

• **High capex for cleaner energy**
The increase in temperatures around us are more perceptible today; unlike 5-6 decades ago when this was so gradual that the difference was not felt. One of the landmark efforts towards limiting this temperature increase has been the Paris Agreement of 2015, where nations collectively agreed to keep warming "well under 2.0°C" through mitigation efforts^[1]. Given government push, we anticipate

sizeable capital expenditure as companies transition towards reducing carbon foot print and having more sustainable energy sources.

In India we have seen a leapfrog from Bharat Stage (BS) IV to BS VI norms, FAME I & II (Faster Adoption and Manufacturing of Electric vehicles) to promote faster transition to EVs (Electric Vehicles), and expeditious rollout of CGD (City Gas Distribution) to cover ~70% population by 2021 ^[2]. The automobile sector and the energy are going through multiple rounds of investments to accommodate these changes.

Clean Energy – The government has set itself an ambitious target of 175 GW of renewable energy capacity and within that 100 GW of solar capacity over the next few years^[2]. It is pushing for wider adoption of clean energy technologies through various policy initiatives aimed at creating demand- and supply-side incentives for developers and mandating states to procure 21% of their energy requirements through renewable sources. Existing power generation companies depending on conventional fuel like coal are re-modelling their business plans to accommodate renewable sources of energy.

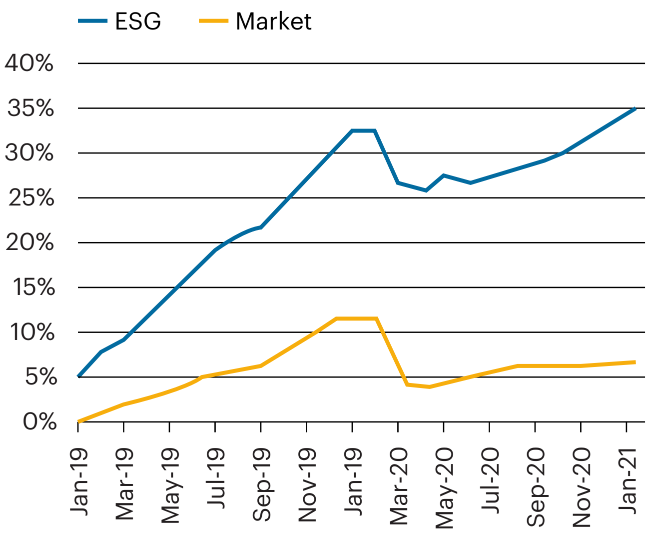
Vehicle Scrappage policy - Proposal to levy 'Green tax' on old vehicles; Jal Shakti Abhiyan^[3] – policy to save water etc. which make us believe the seriousness which is being accorded to the containment of damage to the environment. These will clearly create business opportunities for entrepreneurs.

Today, as we pen this article, some other interesting technologies to counter environment deterioration that we read apart from electric cars are non-combustible sources of power, carbon capture, hydrogen as the new fuel etc.

We are also witnessing increase in Sustainable bond issuance. Capital raised through Green bonds issuances are used to fund projects which have positive environmental impact or have sustainability benefits. Calendar year 2020 saw almost 60% jump in global sustainable debt issuance to USD 530 bn^[4]. We observe lot of corporates trying to tap the Green Bond market where proceeds from debt issuance will be used for these targeted projects.

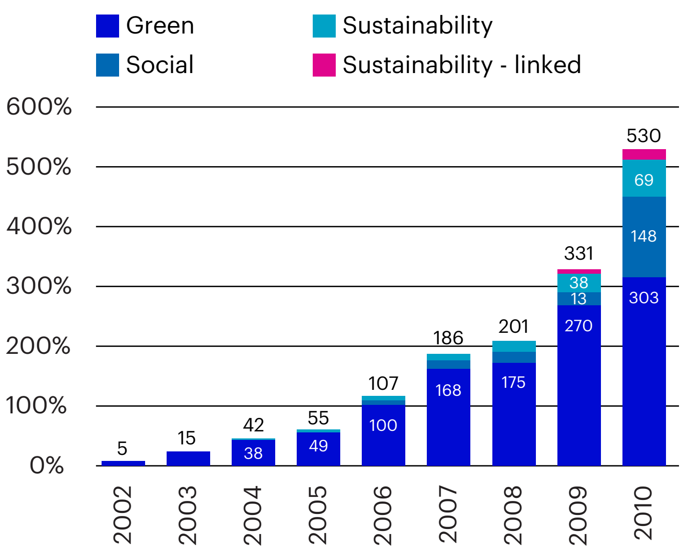
The growth of sustainability debt issuance (USD billion)

Fixed Income: Annualized net inflows/outflows as % of starting AUM



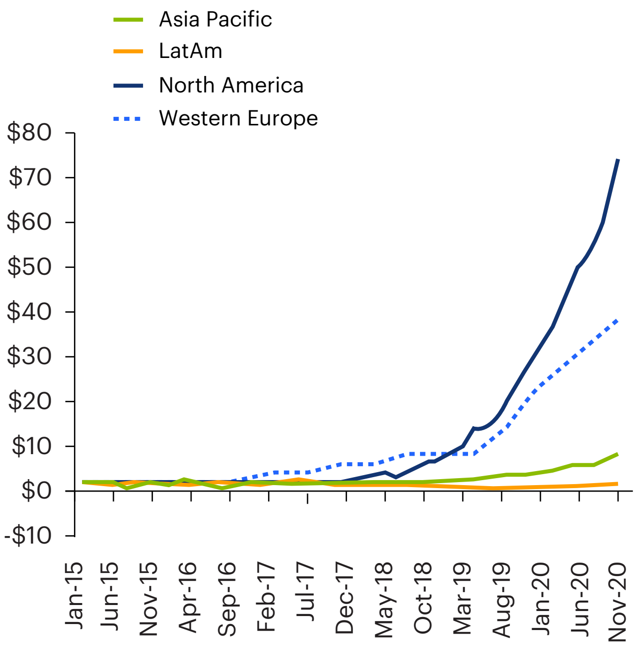
Source: Morningstar

The growth of sustainability debt issuance (USD billion)



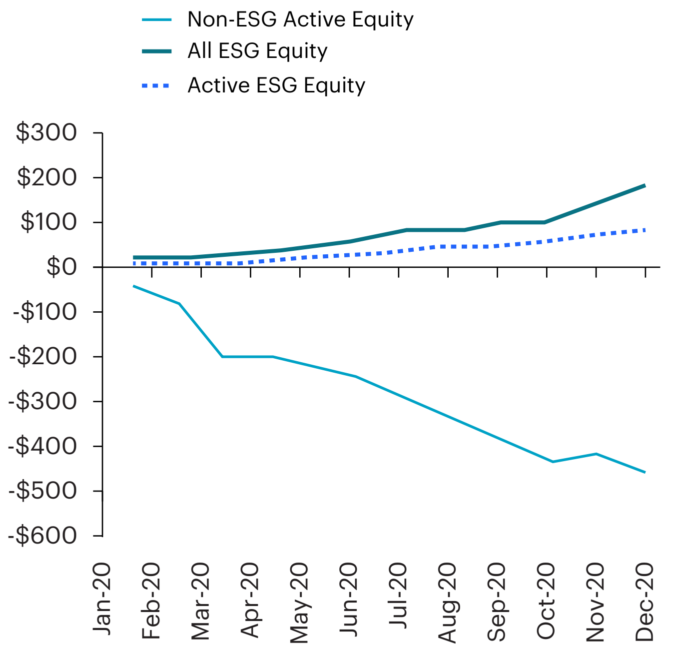
Source: BNEF, Invesco. Data from Jan 2012 to Dec 31, 2020.

Cumulative Flow inti Regional ESG Equity Funds ($bn)



Source: EPFR Monthly Data, Bernsten analysis

Cumulative Flow inti Regional ESG Equity Funds ($bn)



Source: EPFR Monthly Data, Bernsten analysis

Disclaimer - The purpose of above chart is only to explain change in investment pattern and behavior of investors. The information alone is not sufficient and shouldn't be used for the development or implementation of an investment strategy. It should not be construed as an investment advice to any party.

At the same time we see several large corporates participate to reduce the damage to the environment, as they declare targets to become carbon neutral in the years to come. Some of these target dates stretch out to 2035 till 2050 but we take encouragement from the fact that this risk has been recognized and the corporates are course-correcting their business plans.

Rising demand for Socially Responsible Solutions

One reason why S in ESG has traditionally lagged E and G because it has lacked a catalyst for universal recognition. Tragedies such as COVID-19 or an event like the George Floyd case in USA could prove pivotal in this respect. History may yet record 2020 as the year when organizations and investors truly grasped the importance of inequality and social concerns. It is too early to say if this means that S will remain a focus within the mainstream for the longer term. Yet our experience off late is that it increasingly forms a substantive part of the overall ESG conversation, whereas in the past it might have amounted only to an afterthought or even elicited no discussion at all.

Some of the important social issue gaining ground have been:

- Increase in minimum wages & Gender Diversity. While familiar issues such as gender diversity and wage disparities might have dominated previously, today the full extent of an entity's social obligation is more likely to enter the reckoning.
- Fairer treatment by balancing the interest of all stakeholders such as employees, shareholders, management, suppliers, customers, and the community.
- Reduced demand for certain products like tobacco, alcohol & gambling as the communication of ill-effects of same increases.
- Increased financial inclusion across various sections of society and the rise of technology/ are enablers of that.

We understand implementation of these changes may result in increase of costs, in the short term, as corporates prepare themselves to adopt and adapt to the new diversity. This change, in the long term, would help corporates strengthen the relationship with all their stakeholders – improving the acceptability in the new world.

In India, we are enthused to see the government's efforts to improve the social fabric of our nation. Some of the announced policies are:

Pradhan Mantri Jan Dhan Yojana: One of the largest government plans to promote financial inclusion of the non-banked population, especially in the lower income strata. This has removed the inefficiencies involved in implementation of social schemes – like subsidies and grant disbursals and the benefits have reached the targeted population.

Pradhan Mantri Awas Yojana: "Housing for all" with a specific target of building 50 million low-cost houses by 2022. Creates an opportunity for lot of real-estate and ancillary companies like cement, ceramics, consumer durables etc.

Ayushmaan Bharat (National Health Protection Scheme): Providing universal healthcare insurance. It aims to cover over 100 million poor and vulnerable families providing coverage of up to INR 500,000 per family per year. This we believe will boost healthcare spend in India as this insurance shall help cover medical expenses.

Impact of Changing Governance Standards

ESG investing in India is still in its early stage when compared to other countries, and in fact has been dominated by G (governance) over the previous decade. However we see clear transition in corporate India towards following trends:

- **Independent boards**
  We have seen concerted efforts by the regulators in improving the governance standards post the "Satyam saga" in 2009. The regulators have implemented some important policy changes over the previous few years. Various guidelines on independence of directors, responsibilities of board of directors and audit committee, tenure, and remuneration of directors.

- **Higher representation of Women directors on boards**
  Over the previous decade we have seen an improvement in the proportion of women directors in the board rooms as appointment of at least one women director was mandated by the regulator.

- **Improved disclosures in accounts:**
  One doesn't fail to notice the improvement in accounting standards to reflect the true "financial health" of businesses and also an increase in the amount of disclosures in annual reports – specially linked to transactions with related parties of the promoters.

- **Increased disclosures on sustainable standards**
  In India, the regulator has introduced BRSR (Business Responsibility and Sustainability Report) a report with information pertaining to E, S & G factors to be released annually by the top 1000 companies (by market capitalization) mandatorily from financial year 2023. BRSR is a significant upgrade of the BRR (Business Responsibility Report) which was till now being published. This will lead to a material increase in the disclosures on qualitative and quantitative basis.

To Construe...

The efforts taken by the government to improve the environmental and social health of our country will create new business opportunities. We are witnessing several corporates make capital allocation decisions to benefit from these. Simultaneously, we see a lot of vibrancy in the start-up world, where numerous entrepreneurs are striving to convert ESG compliance as profitable business opportunities.

We notice corporates aligning the business plans to accommodate ESG related goals to ensure better compliance and thus reduce the risk which may play out in future. Several corporates have announced plans to reduce carbon emissions, plans to improve the gender diversity in the workforce and at the board, and make improvements to board structures to achieve higher independence and better representation from different fields. These changes may involve higher costs in the short term, but our sense is investors are willing to look through this and ascribe a higher valuation multiple to the companies that are fast aligning to lower the ESG risk in the business. This can be witnessed in the valuation multiples differential within sectors, wherein companies leading in this journey are attracting premium valuations when compared to those companies which are lagging.

We are even more enthused by the fact that corporates are willing to engage with investors to understand the best practices related with ESG and accommodate the same in the business plans.

The ESG investing journey in India over the next decade to our mind would be driving a lot of changes, given our late start and hence from an impact perspective the maximum benefit could be realized here by investors. Winners of tomorrow will be the ones who might adopt necessary adjustments and changes with regards to sustainable investing.

Source:

1. Wikipedia - https://en.wikipedia.org/wiki/Climate_change ,
2. Edelweiss
3. ibef.org
4. Morningstar

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