WHITEPAPER

The path to net zero:

Acuity’s investor scorecard to assess corporate preparedness

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Key takeaways

- Corporate net zero pledges differ significantly beneath the surface/headline details. While many companies are speaking the right language with regard to climate-related commitments, very few have set credible strategies that would help deliver on their pledges or have established quantitative KPIs that investors could monitor to track progress

- Capital markets have, in our view, underestimated – and not entirely priced in – the impact that adaptability to climate risks, and net zero preparedness, would have on long-term returns, debt-servicing ability, rating actions and corporate valuations. Companies operating in carbon-intensive sectors, for example, would need to make significant changes to their business models, including capital investments and divestitures, which could pressure profit margins and cash flows

- However, the risks of inaction, are, in our view, much larger over the longer term. While government intervention has so far been limited, we expect increasing regulatory action with regard to emissions over the next 5-10 years as urgency surrounding climate change intensifies. Companies that are unprepared for the transition to net zero would be caught unawares by regulatory intervention and be the most impacted. **The recent landmark ruling by a Dutch court mandating multinational oil and gas company Shell to accelerate/intensify its decarbonisation plans is, in our view, a precursor of things to come in terms of legal/regulatory intervention**

- Investors wanting to target/invest in net zero issuers should, therefore, make detailed assessments of corporate decarbonisation and net zero commitments to identify firms with effective/meaningful plans that are best prepared to transition to, and function in, a low-carbon economy. This could be achieved through the use of robust and comprehensive scoring frameworks

- Acuity Knowledge Partners' (Acuity's) proprietary net zero scoring framework looks beyond headline net zero targets, which may appear similar across companies but differ significantly in terms of details and execution. Our scorecard captures these nuances and systematically ranks corporates on a four-point rating scale ranging from "net zero early adaptor" to "net zero laggard"

- Our comprehensive scoring criteria covers 14 qualitative and quantitative factors across four pillars and offers clients a standardised tool to compare net zero pledges across companies, sectors and geographies. It functions as a guide for pro-climate investors to enhance decision making regarding capital reallocation aligned with a low-carbon economy

Net zero investor factsheet

Net zero targets set, or under consideration, by over 140 countries (around 90% of global emissions)

- Corporate net-zero commitments have tripled over 2019-21
- >1,500 companies have a net zero target of 2050 or earlier

The Net Zero Asset Managers Initiative represents 220 signatory firms managing over USD50tn of AUM

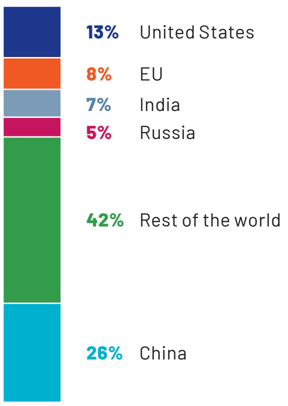
Source: World Economic Forum, Climate Action Tracker, Net Zero Asset Managers Initiative

50% of investors polled in a recent survey* stated that asset managers should use their influence as shareholders to facilitate reduction carbon emissions reductions

32% of investors polled in the survey stated that, regardless of return, they were happy for their cash to be used for carbon emissions reductions

** Survey of >6,000 individual investors across 10 markets by global investment management firm Ninety One*

Source: Ninety One



- The world's top 10 emitting countries account for >60% of annual GHG emissions
- The top 3 GHG emitting countries contribute >15x the annual emissions of the bottom 100

Source: World Resources Institute, Climate Watch, 2018

A recent survey by BlackRock* shows that among ESG factors, 88% of global respondents ranked the environment as their #1 priority

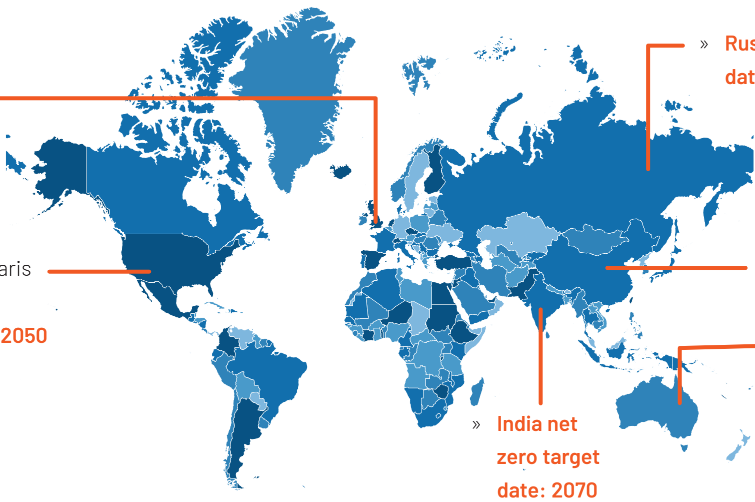
Climate-focused investment funds attracted significantly more cash over January-October 2021 vs ESG funds focused on other areas of sustainability, according to WSJ and Morningstar

** BlackRock 2020 Global Sustainable Investing Survey covering 425 investors across 27 countries*

Source: BlackRock, Wall Street Journal via Morningstar

- **UK net zero target date: 2050**
- 78% emissions reduction by 2035

- The US rejoined the Paris Agreement in 2021
- **Net zero target date: 2050**
- 50-52% reduction in emissions by 2030



- **Russia net zero target date: 2060**

- **China net zero target date: 2060**

- **India net zero target date: 2070**

- **Australia net zero target date: 2050**
- 30-35% emissions reduction by 2030
- Will not legislate its net zero target

Source: Mercator projection, Acuity Knowledge Partners

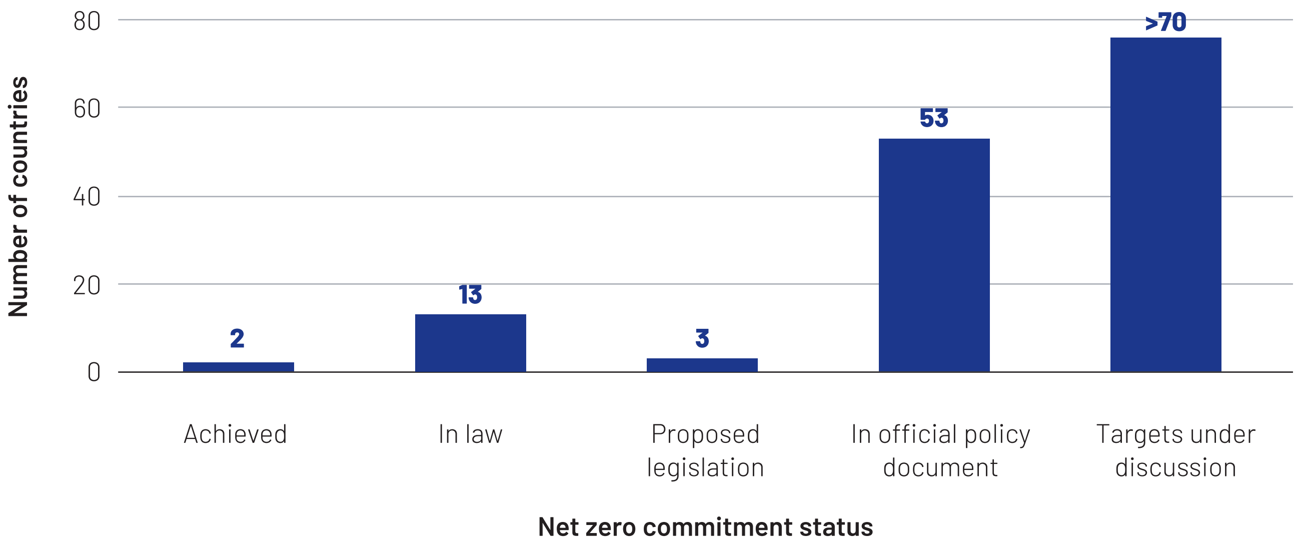
Investor considerations in the transition to net zero

Headline net zero targets are meaningless if not backed by a credible policy/plan

A growing number of countries are making net zero pledges, including some of the world's biggest carbon emitters that previously resisted making climate-related commitments, such as Australia, India and Russia. As of early November 2021, over 140 countries had submitted updated, or new, nationally determined contributions (NDCs), outlining their emissions reduction/net zero targets and mitigation/adaptation measures, covering roughly 90% of global emissions.

However, many of these national net zero pledges are, at present, vague and not backed by effective, or clear, plans and strategies. Formal policy action has not been taken to legally ratify a majority of these pledges, which are currently at the discussion/proposal stage and have no official standing. Nevertheless, we expect these plans to gradually solidify and become more credible, as lagging countries face growing pressure – from climate activists, pro-climate countries/politicians and business leaders – to act on their climate pledges.

Fewer than 15 countries have passed their net zero targets into law



Source: Energy & Climate Intelligence Unit, November 2021

In tandem with the rise in national net zero commitments, a growing number of corporates (>1,500 as of October 2021) are adopting science-based targets and pledging to reach net zero by 2050 or sooner. These include industry giants from high-emission sectors (oil and gas, transport and industry), such as Delta Airlines, Holcim and Haliburton. This corporate decarbonisation push has not been driven by government intervention to set emission targets/deadlines. Instead, mounting societal and investor pressure has been the main driver of corporate climate pledges, supported by stewardship efforts such as engagement and proxy voting. A recent survey by BlackRock found that of environmental, social and governance (ESG) factors, 88% of global respondents place environmental factors as their #1 priority. A similar survey by asset management firm Ninety One found that 32% of investors polled stated that, **regardless of return,** they were happy for their cash to be used to facilitate carbon emissions reductions. Similarly, on the fixed income side, rating agencies have incorporated ESG factors into their rating methodologies, and these factors are increasingly affecting rating decisions. At S&P, for example, around 30% of corporate rating actions over April-December 2020 were affected by ESG-related considerations, of which 14% were environmental factors.

Fuel emissions risk for auto manufacturers could drive future rating actions

Under current EU emissions performance standards, car manufacturers face penalties of EUR95 per vehicle for every gram of CO_2/km by which they exceed their emission targets. Manufacturers that fail to meet their targets could face hundreds of millions of euros in fines, which could, in turn, drag down profitability and lead to rating downgrades.

Fuel emissions risks – and the associated financial costs – have already been cited by credit rating agencies as a key rating driver in some of their recent rating actions relating to auto manufacturers, including Daimler AG and Renault.

Similar to differences in the effectiveness and feasibility of national net zero targets, **corporate net zero pledges also differ significantly beneath the surface/headline details. While many companies are speaking the right language with regard to climate-related commitments, very few have set credible strategies that would help deliver on their pledges or have established quantitative KPIs that investors could monitor to track progress.** Moreover, several corporates have failed to address scope 3 greenhouse gas (GHG) emissions – which could account for a predominant share of a company's overall emissions in some sectors (such as automobile manufactures and oil and gas companies) – in their net zero plans. Other companies have prioritised the use of carbon credits, over reductions in operational emissions, in their net zero plans. This could be a type of greenwashing, given that verifying the actual neutralising impact/environmental savings of offset projects can be difficult.

Investors wanting to target/invest in net zero issuers should, therefore, make detailed assessments of corporate decarbonisation and net zero commitments to identify firms with effective/meaningful plans that are best prepared to transition to, and function in, a low-carbon economy.

Regulatory intervention is likely to intensify; investors should identify well-prepared companies

Capital markets have, in our view, underestimated – and not entirely priced in – the impact that adaptability to climate risks, and net zero preparedness, will have on long-term returns, debt-servicing ability, rating actions and corporate valuations.

Companies operating in carbon-intensive sectors would, for example, need to make significant changes to their business models, including investments and divestitures, which could pressure profit margins and cash flows, potentially resulting in negative implications for investors in the form of reduced dividends or falling share prices. This is likely the main reason some companies have been reluctant to make real/meaningful changes to their operating models and have instead opted for easy shortcuts and near-term solutions, appearing to the public as taking steps to be environmentally friendly while largely carrying out business as usual.

However, while the transition to net zero can impact cash flows and shareholder returns over the short term, **the risks of inaction, are, in our view, much larger over the longer term. While government intervention has, so far, been limited, we expect increasing regulatory action with regard to emissions over the next 5-10 years as urgency surrounding climate change intensifies.** Companies that are unprepared for the transition to net zero would be caught unawares by regulatory intervention and be the most impacted. **The recent ruling by a**

Dutch court mandating Shell to accelerate/intensify its decarbonisation plans is, in our view, a precursor of things to come.

Landmark climate litigation case: a shift from ruling on liability suits to mandating emissions reductions

In a first-of-a-kind ruling in May 2021, a Dutch court ordered Royal Dutch Shell Plc (Shell) to slash its global net carbon emissions by 45% (on an absolute basis) by 2030 vs 2019 levels. The court further ruled that Shell is responsible for scope 3 emissions (indirect GHG emissions created by both customers and suppliers). The case was filed by environmental campaigners.

The targets set by the court were far more aggressive than Shell's short-term targets, which involved a 20% reduction in emissions (vs 2016) by 2030 and a 45% cut by 2035, with a goal of reaching net zero by 2050. At the time of its net zero strategy announcement, the company was not explicitly addressing scope 3 emissions.

The watershed court ruling marks a shift away from previous climate cases, which mainly involved rulings on fines/payments to be made by oil and gas companies in liability cases (e.g., oil spills), and sends a strong signal that corporations that do not voluntarily take climate-related action can be forced by the courts to cut emissions. Other major polluting sectors, such as airlines and steel and mining, could see similar litigation going forward. Environmental activists have also indicated plans to target financial institutions that finance fossil fuel projects.

Pro-climate investors can broadly select from among three strategies to align their portfolios with climate change-related goals:

- **Divest:** exit from or phase out or minimise exposure to high-emission sectors/companies (e.g., energy, manufacturing)
- **Target:** reallocate capital towards emerging players in climate-friendly sectors, such as clean/renewable energy, electric-vehicle (EV) and battery manufacturers and carbon capture and storage (CCS) companies
- **Engagement:** engage with carbon-intensive companies to promote decarbonisation efforts and vote against companies who are (1) facing allegations of greenwashing; (2) involved in climate-related controversies; or (3) failing to meet climate-related requirements and disclosure

Investors should keep in mind that companies that have historically been market leaders and stock-market darlings will not inevitably be the winners of the next decade. Climate investing will likely be the predominant theme of the next two decades, and incumbents that successfully navigate the transition and conform to regulatory changes will emerge as leaders. Asset managers who maintain exposure to carbon-emitting companies should, therefore, have robust and comprehensive scoring frameworks in place to mitigate their investment risk.

"We know that climate risk is investment risk. But we also believe the climate transition presents a historic investment opportunity" – Larry Fink, *Chairman and Chief Executive Officer, BlackRock, 2021*

Acuity’s net zero preparedness scorecard

Introduction

Acuity’s ESG practice provides customised and bespoke support to over 400 financial institutional clients across the entire ESG research value chain, including SDG research, analysis of ESG-linked credit instruments, ESG/SDG/greenwashing risk ratings, net zero alignment ratings, issuer engagement research and questionnaires, data science for ESG research and SFDR/EU taxonomy disclosure preparation support.

Acuity’s proprietary net zero scoring framework looks beyond headline net zero targets, which may appear similar across companies but differ significantly in terms of details and execution. Our scorecard captures these nuances and systematically ranks corporates on a four-point rating scale ranging from “net zero early adaptor” to “net zero laggard”.

To arrive at a ranking, we assess companies’ net zero pledges on a composite of key measures. Our comprehensive scoring criteria covers a range of qualitative and quantitative factors across four pillars: (1) target, (2) disclosure, (3) progress and (4) credibility. Each pillar comprises several sub-factors, weighted by importance, to minimise subjectivity in the rating process.

Benefits

» **Provides a standardised approach** that enables comparison of net zero pledges across companies, sectors and geographies, creating a single snapshot of climate transition risks and opportunities to be priced in to valuations. Acuity’s experienced equity, credit or commodity experts would thereafter review the financial and business implications of the net zero assessment and support clients in incorporating these into financial models, investment decision making, report writing and shadow rating and rating recommendations

» **Functions as a guide** to enhance decision making regarding capital allocation by identifying companies with credible and well-articulated strategies, while weeding out companies with vaguely formulated plans that are unprepared for the transition to net zero. The scorecard outcomes, therefore, serve as a starting point to initiate interaction/engagement with companies to drive them towards global best practices (in terms of action as well as disclosure)

» **Eases the burden of high-volume, time-consuming work.** Asset managers tasked with evaluating hundreds of seemingly similar net zero commitments may find the quantum of data overwhelming. Acuity will use its proprietary AI-/ML-based technologies for fast data extraction and web scraping to optimise efficiency. Our scorecard then contextualises and converts the data into useful and processable information

Reducing emissions intensity vs absolute emissions: credibility and scoring of carbon offset usage

Many companies that have set decarbonisation targets have pledged to reduce ***carbon/emissions intensity*** *(volume of emissions relative to an organisation-specific unit of output, such as revenue) rather than set targets for* ***absolute reductions in total GHG emissions.*** *This approach, which has been adopted by some oil and gas majors including Shell, allows companies to invest in carbon offsetting projects (e.g., tree planting/ reforestation by third parties) while still carrying out business as usual (i.e., without absolute operational emissions cuts).*

Offsetting is, however, improperly regulated at present, and verifying the actual neutralising impact/ environmental savings of offset projects is difficult, leading to scepticism and accusations of greenwashing by climate activists and regulators.

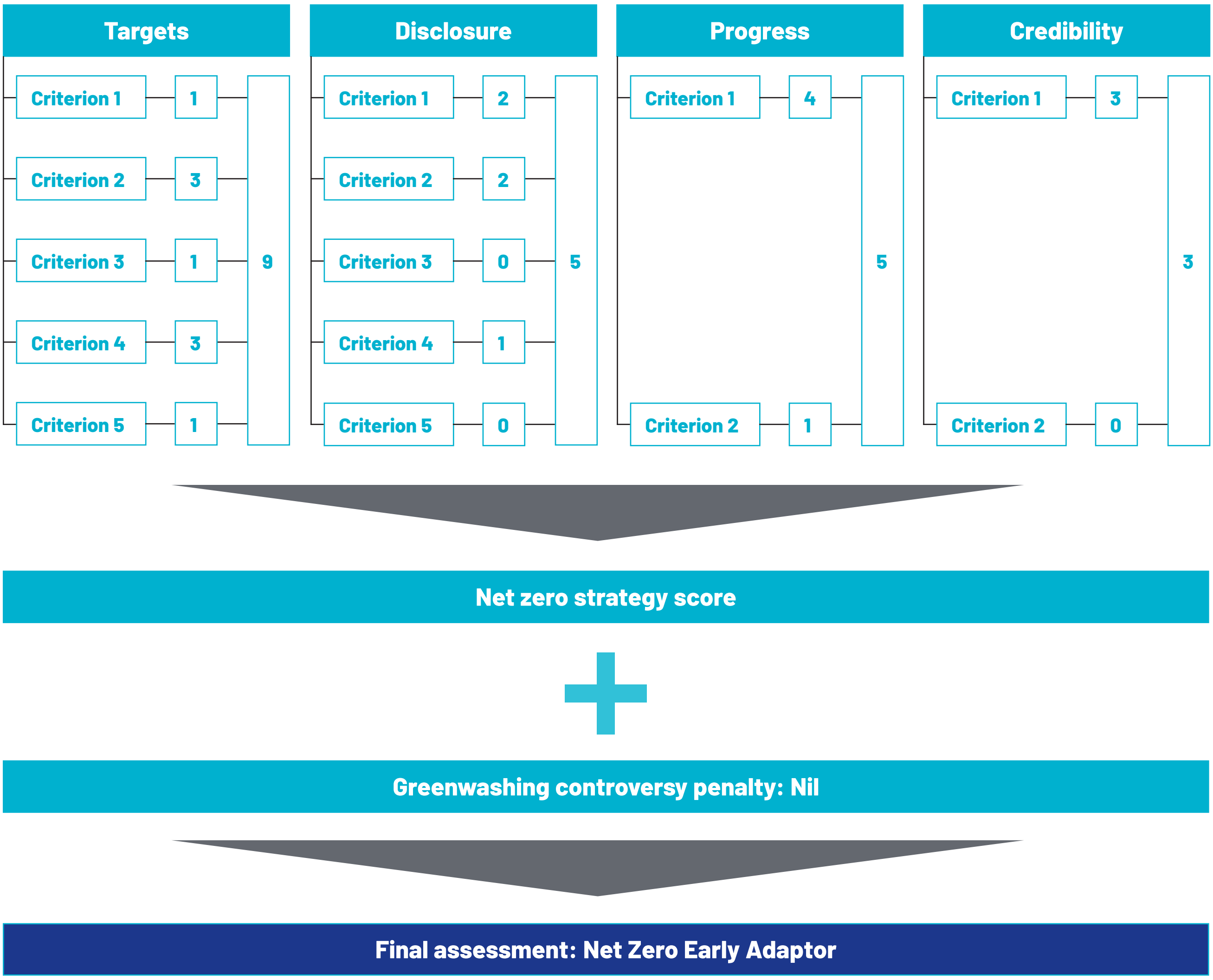
Shell, for example, was recently asked to stop running a "misleading" advertising campaign involving carbon offsets – Drive Carbon Neutral – by the Netherlands' advertising watchdog. The company's Glengarry tree-planting carbon offset project has also been challenged as questionable by Greenpeace and non-profit Source Material. Two more of its offsetting projects are being scrutinised to assess their actual climate benefit.

We believe investors will demand more credibility from companies in terms of their net zero strategies going forward, as well as commitments to science-based targets and absolute emissions reductions. As such, our scorecard rewards companies that have pledged absolute reductions in total GHG emissions over companies relying more heavily on carbon offsets to reach net zero targets. Our scoring also incorporates penalties for companies involved in greenwashing-related controversies.

Sample analysis and scorecard output

We provide a sample of our analysis, and ranking, of a corporate in our net zero database below. Our scorecard ranked our sample issuer – a UK-based consumer discretionary company – as a **"net zero early adaptor",** mainly due to a clearly defined and credible strategy coupled with excellent disclosure/transparency on KPIs, progress and results. The issuer had no greenwashing penalties, and had included scope 3 emissions in its net-zero targets

SAMPLE CORPORATE NET ZERO ASSESSMENT SCORECARD OUTPUT



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Lourdeena Kudaliyanage has over 12 years of experience in investment research. At Acuity Knowledge Partners (Acuity), she is part of the Fixed Income and Credit Research team in the Investment Research vertical. During her tenure at Acuity, Lourdeena has supported leading buy-side and sell-side firms covering multiple sectors, focusing primarily on frontier and emerging markets, with expertise in thematic and company research. She is a CFA charterholder and holds a BSc Econ (Hon.) and an MSc in Financial Management from the University of London.

The author would like to acknowledge the contribution made by Jehan Saldin, a senior associate in the Fixed Income and Credit Research team.

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About Acuity Knowledge Partners

Acuity Knowledge Partners (Acuity), formerly part of Moody's Corporation, is a leading provider of bespoke research, analytics, staffing and technology solutions to the financial services sector.

Headquartered in London, Acuity Knowledge Partners has nearly two decades of experience in servicing over 400 clients by deploying its 4,000 specialist workforce of analysts and delivery experts across its global delivery network. We provide our clients with unique assistance to innovate, implement transformation programmes, increase operational efficiency, and manage costs and improve their top lines.

Our expertise includes the following:

» Investment Banking: origination and trading support
» Investment Research support: covering all asset classes in terms of ideation, data science, and research support across the buy side and sell side
» Commercial Lending support: across origination, credit assessment, underwriting, and covenant and portfolio risk for all lending types
» Private Equity: origination, valuation and portfolio monitoring support
» Asset Management services support: across marketing, investment research, portfolio management/ optimisation, risk and compliance
» Corporate and Consulting services: market and strategic research; survey work; treasury and counterparty risk support; and CEO office support, including M&A, FP&A and investor relations support
» Compliance support: AML analytics, KYC, counterparty credit risk modelling and servicing across banks, asset managers and corporates
» Data Science: web scraping, data structuring, analytics and visualisation These services are supported by our proprietary suite of Business Excellence and Automation Tools (BEAT) that offer domain-specific contextual technology.

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