FIERA CAPITAL

MAY
2023

Investing for a Low Carbon World

It seems that no matter where you live in the world, not a year goes by without some kind of extreme weather event. It is just one of many early warnings signs that we are on an unsustainable climate trajectory.

The Intergovernmental Panel on Climate Change (IPCC) predicts that we will need to limit global warming to a maximum of 1.5 degrees, a threshold beyond which we will see extreme temperatures, rising oceans, destruction of coral reefs, amongst many other critical issues.

To keep global warming to no more than 1.5°C – as agreed to by most countries at COP26 in 2021 – greenhouse gas emissions need to be reduced by 45% by 2030 and reach net zero by 2050.

There is some confusion as to what net zero entails. 'Net zero emissions' refers to achieving an overall balance between greenhouse gas emissions produced and greenhouse gas emissions taken out of the atmosphere. The more emissions that are produced, the more carbon dioxide we need to remove from the atmosphere to reach net zero. Given the challenges inherent in sequestering carbon, new emissions of greenhouse gas must be as low as possible.

In other words, we need to get emissions as close as possible to absolute zero and only rely on netting off (i.e., offsetting) when absolutely necessary. This means that we need to rapidly transition away from fossil fuels to renewable energy as soon as possible. If we continue to emit as much as we are today until 2049 and then suddenly stop, we are not in fact achieving net zero or limiting global warming to 1.5 degrees. The more we emit in the first 15 years, the more we will need to be aggressive in the second 15 years to cut those emissions. Put differently, net zero is more about the journey than the destination, and the sooner we take action the greater our chances.

The world reached a milestone in 2022 where, for the first time in history, investment in the energy transition equaled global investment in fossil fuels according to BloombergNEF[1]. Their data showed that investment into upstream, midstream, and downstream oil and gas activities, and into fossil fuel-fired power generation without emissions reduction technology, was $1.1 trillion. Likewise, annual investment in renewable energy, electrified transport and heat, energy storage and other technologies also reached $1.1 trillion.

While this is undoubtedly good news, to achieve net zero many forecasters believe that the total investment into the energy transition will need to increase by a factor of 3-5x, or approximately $3-5 trillion per year for the next 30 years, for a total cost of up to $150tn.[2]

Governments and Businesses are starting to take more assertive action. In the past year, the world's three major economic axes of the U.S, EU, and China have all made major announcements. In August 2022, the U.S. passed the Inflation Reduction Act with $369 billion in investment earmarked for energy security and climate change sectors. In May 2022, the EU's REPowerEU plan released an upgrade to its already ambitious Energy Transition goals from the prior "Fit-for-55" package. At the same time China reiterated its commitment to reach peak CO_2 levels by 2030 and net zero by 2060 and the region is making some of the greatest gains, having spent twice as much as the US on climate action in the last decade.

At a company level, BofA Global Research estimates that 68% of European companies, 48% of US companies, and 41% of companies in Asia have already set net-zero targets and nearly all the remaining companies claim to have net zero carbon emissions as an 'integral' part of their decision-making process.[3] Therefore, regardless of any particular investment bias or style (growth or value), asset class (debt or equity), or format (public or private), all investors will inevitably have to have a framework for thinking about how the energy transition impacts their portfolio companies.

The net zero transition is clear

Unsurprisingly there has been an explosion of interest in investment themes linked to the energy transition. There is an obvious appeal to invest alongside opportunities that promise to deliver the holy grail of both financial and sustainability outcomes. While there are many thousands of individual subcategories, the most cited themes include renewable energies, electric vehicles, batteries and storage, LEDs and Lighting, internet of things (IoT), amongst others.

Adding to the appeal is the enormous scale of growth that needs to be accomplished in each of these areas to achieve net zero. To remain on track, it is estimated that by 2030 we would need to see renewable power additions tripling (and greater than 10x by 2040), 60% of car sales being electric (c.100% by 2040), and a staggering 18x increase in global battery demand (nearly 50x by 2040). Further, we also see the potential for green hydrogen, given the expected 8x in demand an >300x increase in electrolyser capacity expected over the next 10-20 years.

One of the most interesting and appealing aspects to renewables is the increasing inevitability of their success. While historically many renewables required significant subsidies to be cost competitive with fossil fuels, that is no longer than case in many locations and applications around the world. There are structural reasons why this incremental cost advantage in favor of renewables will continue beyond the policy stimulus it has so far enjoyed.

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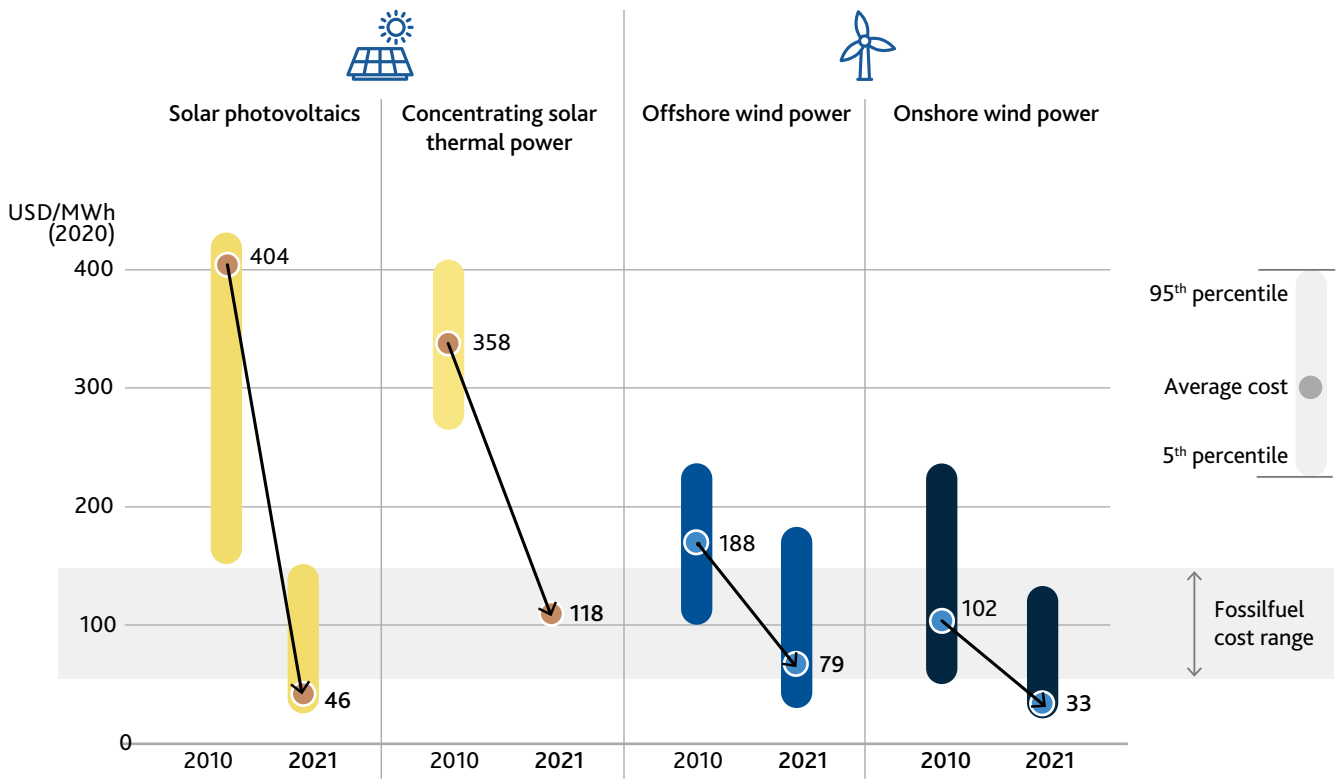
>
> Source: Bloomberg (January, 2023)

1. Bloomberg (January 2023) **2.** BofA Global Research, "Net Zero 2.0" (31 October, 2022)
3. BofA Global Research, "ESG Matters, 5 Themes for the year (or years) ahead" (January 27, 2023)

The cost curve for renewable energy sources is rapidly decreasing as they are greatly influenced by the pace of technological innovation. They follow learning curves, often described as Wright's Law, which describes a situation whereby for every doubling of cumulative production, the unit cost drops by roughly 20 percent. Key to this is that technologies such as solar are essentially manufactured in a factory, resulting in a highly standardized and iterative process which constantly improves upon the amount of labor, time, energy, and raw materials needed to produce the technology. In contrast, the cost curve for fossil fuels is rising and steepening through time due to two main factors (1) geology; the marginal deposit is increasingly more difficult and costly to extract due to factors including location, geometry, and grade (2) construction costs; there continues to be a persistent rise in the cost (and size of cost over run) of capital intensive projects, particularly mega-projects.

Exhibit 1: Significant Declines in the Levelized Cost of Energy (LCOE) for Renewables, Falling Below the Fossil Fuel Range

Global Weighted-Average LCOEs from Newly Commissioned, Utility-Scale Renewable Power Generation Technologies, 2010-2021



Note: These data are for the year of commissioning. The thick lines are the global weighted-average LCOE value derived from the individual plants commissioned in each year. The LCOE is calculated with project-specific installed costs and capacity factors, while the other assumptions are detailed in the Power Generation Costs 2021 report from IRENA. The single band represents the fossil fuel-fired power generation cost range, while the bands for each technology and year represent the 5th and 95th percentile bands for renewable projects. No price range was available for CSP. In 2021 there was only one CSP plant comissioned, as many projects have been delayed.

Source: IRENA Renewable Cost Database, 2021

Investing in net zero is complex

While the demand and revenue growth potential of the net zero 'theme' is clear, the level of profit and return potential is much less certain.

One aspect that is often not fully appreciated is that, ultimately, units of energy are effectively a commodity regardless of the source. Commodity like products that lack differentiation, are typically priced close to the marginal cost of production yielding cost of capital type returns. And as we have learnt, and according to Wrights Law, the exponential growth in volume required to meet net zero goes hand in hand with the exponential decline in cost, forming a positive iterative feedback loop. Nevertheless, as price follows cost, it does mean that there can be an unfortunate side effect – each incremental unit of volume may come with a smaller dollar profit margin.

This is perhaps best explained with an example. A company selling a commoditised widget for $100 in 2020 for a 10% profit margin would make $10 of profit alongside $90 of cost. If both price and cost decline 90% over the subsequent 10 years then, as price falls to $10 and costs fall to $9, and while margins are still 10%, the company only makes $1 in profit. Or thinking of it another way, the company would need to sell 10x the number of units just to keep profits flat over a 10 yr period.

However, investors don't invest in real assets for a flat profit growth scenario. A typical rate of return threshold (or hurdle rate) might be 10% per annum. At that rate, by 2030 investors would want profits of $26 ($10 compounded at 10% for 10 years = $26). For that to occur, a $1 profit per unit outcome would require a 26-fold increase in volumes to meet investors' return hurdle. Not impossible, but certainly a challenge when operating in a commoditised industry with low barriers to entry. Under such conditions, the pool of investable opportunities that can steadily and reliably grow profits shrinks quite quickly, making picking winners over the long term incredibly difficult.

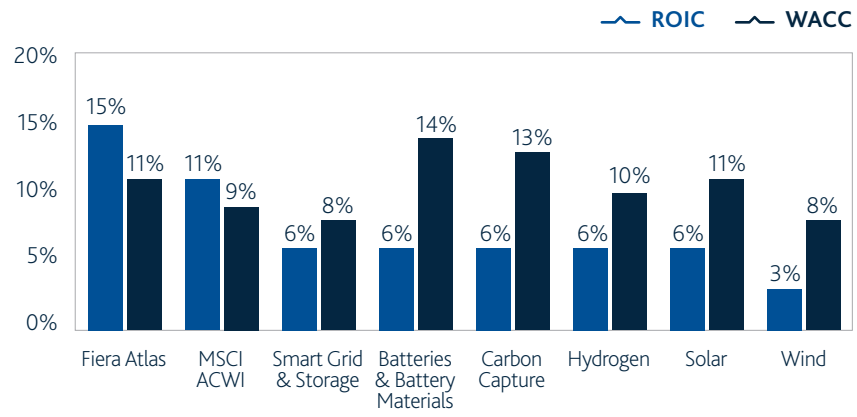
Furthermore, the profit margin shown in the income statement is only one half of the story. The challenge is further compounded when we take into consideration the balance sheet and the enormous amount of capital expenditure that is required to be invested to deliver such large volume growth.

We evaluated the list of companies recommended by BofA Global Research for their exposure to the energy transition 'thematic' according to return on invested capital (ROIC) as well as cashflow stability.[4] We also compared them to their weighted average cost of capital to see whether many of the companies in each thematic subcategory could generate an economic profit (in other words ROIC above Weighted average cost of capital (WACC)).[5] The results show that the vast majority of companies in each of these themes had very low ROIC. In fact, only 4 of the 61 companies in total had a ROIC above their WACC (less than 7% of total companies). Returns were also considerably below the ACWI average of 11%.

Interestingly the lower economic returns do not even come with the benefit of lower carbon intensity. The same 61 companies in each of the energy transition themes we assessed also scored poorly for their direct level of carbon emissions. Again, they scored worse on these metrics compared to the ACWI and our portfolio. Some of these may be quite surprising, such as solar. This is because while the generation of energy from solar panels do not generate carbon, the companies involved in the making of the panels and the components do generate some carbon in the production process. While the total value chain taken end to end is more energy efficient, the component of that value chain which is available to investors isn't the least carbon intensive part.

Exhibit 2

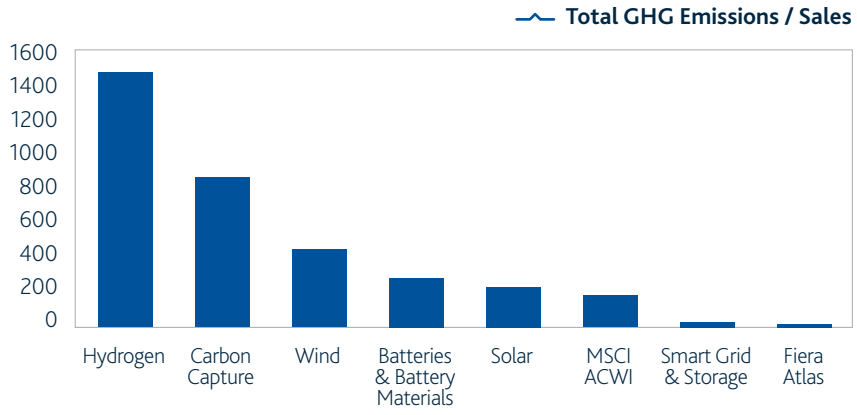
Return on Capital vs Cost of Capital



Source: Bloomberg and CS Holt (January, 2023)

Exhibit 3

Carbon Intensity



Source: Bloomberg (January 23, 2023)

4. Credit Suisse HOLT (January 23, 2023) **5.** Bloomberg (January 23, 2023)

Finally, there are material risk considerations that are hard to forecast and incorporate into a financial model. These include new geopolitical and supply chain risks. While transitioning away from fossil fuels we will see reduced reliance on Middle Eastern and Russian fossil fuel supplies, the growth in renewables and battery electric vehicles resulting in a substantial transition of risk away from the oil sector and towards the mining sector, and geographically towards China.

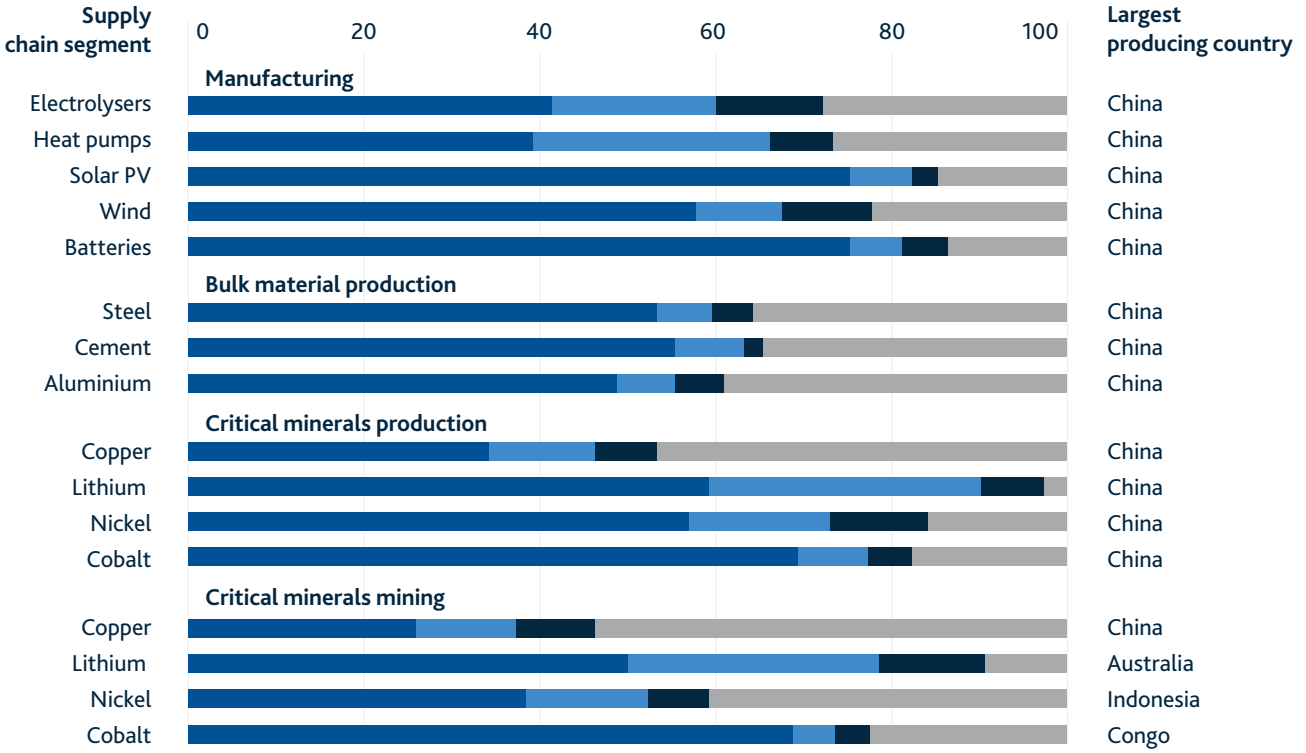
Most of the energy transition relies on solar or wind. In terms of solar, China dominates the supply chain at all levels from 75% of module production to 97% of silicon wafers. In terms of batteries, China accounts for 65% of lithium processing and 74% of battery cell production. China currently controls an average of 69% of global refining capacity of five minerals critical to the production of EV batteries, including rare earths.[6] At its current pace, China is going to need a lot more of this mineral capacity for its own internal use. China is adding more renewables annually than the rest of the world combined. Its pace of development is accelerating, seeing it surge further ahead.

During 2022, China added more than 51 gigawatts of decentralised solar. This is more than the TOTAL clean energy additions (of decentralised solar, utility solar, and wind) from all of the the US, Germany, and the UK put together.[7]

At the end of January 2023, China amended its rules to ban the export of several core solar panel technologies which will hamstring the efforts of the US, EU, and India to develop competitive homegrown industries given China dominates the cutting-edge IP required to produce bigger, thinner wafers that are key to efficiency improvements.

Exhibit 4

Geographic concentration by supply chain segment, 2021



Source: IEA (25 January, 2023)

6. Source: BofA Global Research, "Net Zero 2.0" (31 October, 2022)
7. Exponential View Newsletter (April, 2023)

According to BofA Global Research achieving net zero could require 6x the current amount of mined minerals by 2050, requiring >380 new mines for battery metals alone. For ESG conscious investors, the reduction in environmental risk (from reduced fossil fuel exposure) brings heightened exposure to social risks (from increased labour exposure). For example, for one of the critical minerals required for batteries, cobalt, over 76% of the worlds mined output comes from Africa namely the Congo. Cobalt mining processing, and even polysilicon production for solar have faced intense scrutiny for alleged human rights and health and safety risks. According to a benchmark developed by the Business & Human Rights Resource Centre, most renewable energy companies lack essential human rights, with many companies scoring very poorly on ESG measures.

We are in no way questioning the critical importance of investing in the energy transition. Quite the contrary, the more pertinent question is who is best placed to reliably fund the transition given its importance? It is not clear to us how public market investing will solve some of the biggest challenges of financing the world's net zero goals, amounting to trillions of dollars of incremental expenditure being required each year. At a fundamental level, the secondary trading of securities, whether equity or debt, is simply the transfer of ownership from one entity to another. It does not provide any of the substantial incremental capital required to build new capital stock or make the existing stock more efficient. At the margin, one could argue that the significant flows into Sustainable or Impact Funds and thereby 'green' companies do increase their valuation multiple and reduce the cost of equity, which they could look to take advantage of by raising equity to fund the capex.

However, we shouldn't forget that these same transitional flows and valuation impacts are in the same way hurting the very carbon intensive sectors that need to spend the most in terms of energy transition capex in the coming decades. For example, the materials, utilities, and energy sectors in Europe are hoping to spend around $550bn in green capex over the next five years to remove 1.3bn metric tons of CO_2 per year. Miners need to invest > $800bn additional capex until 2030 just to meet demand for metals important for future technologies, known as 'MIFT'. A similar situation can be found by region, with emerging markets in need of significant investment to transition their energy stock and infrastructure to cleaner and more efficient sources. In summary, we often find that the sectors and economies most in need of capital tend to be those that are increasingly being shunned by investors.

There is plenty of historical precedent to warrant investor caution. During previous infrastructure revolutions and economic transitions in history, such as the railways mania of the 1800s, the telco frenzy of the 1900s, or the fiber internet boom of the 2000s, a huge amount of private capital was destroyed in the process. While the infrastructure is essential, the timeframes to full economic benefit were typically very long and ultimately shared across many participants. Initial bubbles turned to bust as the financial returns to the original capital providers prove low or negative. It raises a question as to who should really fund these ultra-long duration and low yielding projects? Governments are arguably best placed given they have access to ultra-long term and low-cost capital. Pushing the burden of low returns too far onto the private sector will merely create further problems for governments down the road, as pension funds would compound their capital at lower rates exacerbating the retirement crisis in a sector which is already struggling to support an ageing population. Our noble purpose, if we can call it that, is to provide a solution to this very problem, allowing our end investors to compound up their wealth sustainably and at high rates for a long period of time.

With less than 1% of the required $150 trillion in net zero investment so far having been funded, the energy transition is clearly going to require a massive amount of fiscal stimulus from governments, along with support from central banks and multilateral development banks to guarantee consistent access to development capital.

Achieving net zero could require 6x the current amount of mined minerals by 2050, requiring >380 new mines for battery metals alone.

Source: BofA Global Research, (31 October, 2022)

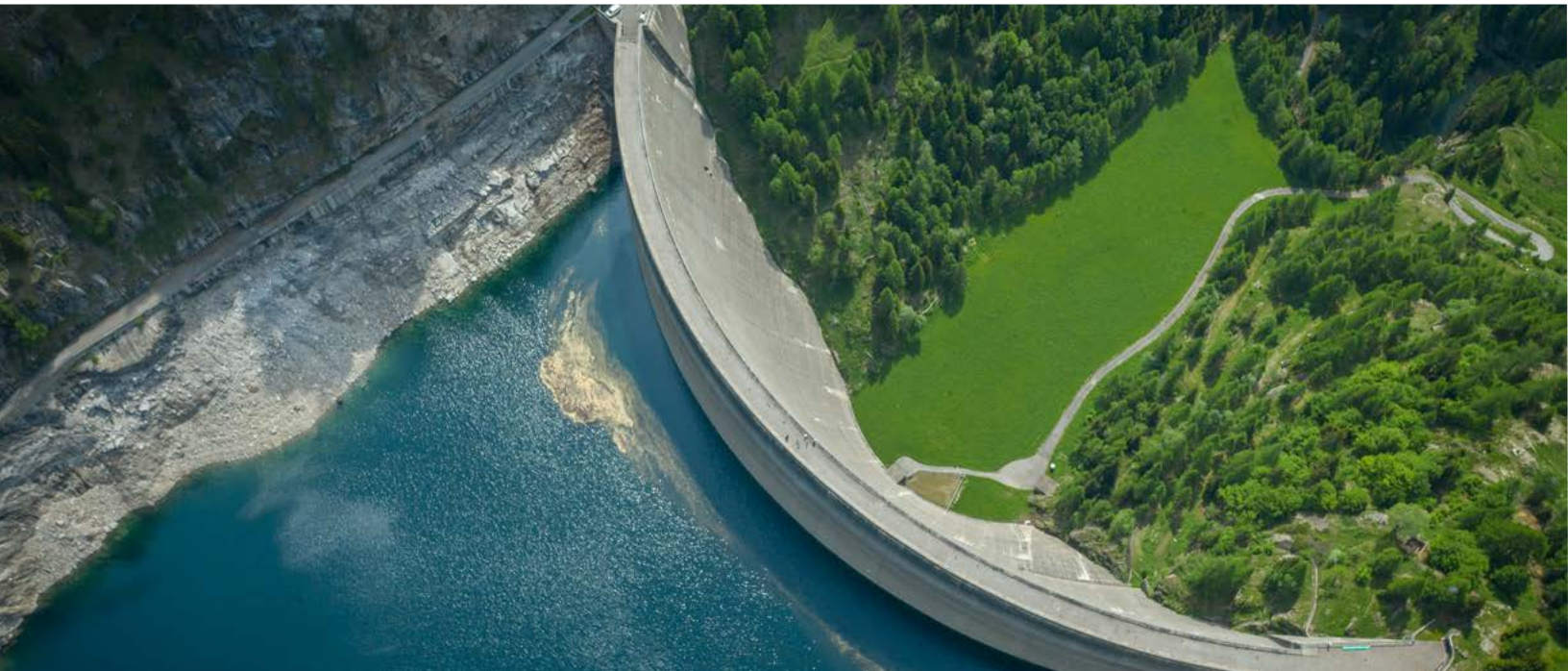
The Atlas approach

Hopefully the analysis outlined so far provides some insight into why we say that investing is a highly nuanced process and a qualitative discipline. Whilst intuitively the idea of backing themes, particularly those relating to the future of energy, does sound very appealing for their growth and their perceived ESG alignment, the reality is much more complex. It is not only quite difficult to generate a sustainable financial return commensurate with the risk of investing in equities, but it is even quite difficult to score well in an ESG sense despite the optics of the 'theme'.

It is also a good reminder that growth does not tell us the whole story. Growth in and of itself does not create additional value, indeed growth below the cost of capital will destroy value. In short, it is only when ROIC above the cost of capital is combined with sustainable and structural pathways to growth can cashflows reliably compound up over time, leading to long term value creation and expansion.

So while we often get bucketed as growth investors, this misrepresents what we actually stand for. As an example, we avoid many hypergrowth companies where the path to profitability is highly uncertain or long dated with paybacks well beyond our 5 years. Equally we avoid quality traps, companies which look fine through the rear-view mirror but are poorly placed to create value going forward because economic profit without economic profit expansion is not going to deliver you much return. First and foremost, we seek high persistent profitability above the cost of capital, a high economic profit, and only then does our attention turn to the growth potential of that economic profit. When we refer to growth, we mean the persistent, above average expansion of long-term shareholder value, not growth in sales or earnings.

Our strategy invests in 25 to 35 exceptional companies with strong wealth creation credentials, backed by sustainable and diversified cash flows that will likely compound over the long-term. Every company needs to score above industry average on all of our wealth creation pillars; competitive advantage, structural growth, capital allocation, and predictability. That's why we call the companies we invest in exceptional as it is genuinely rare to have companies that are strong on all these metrics.

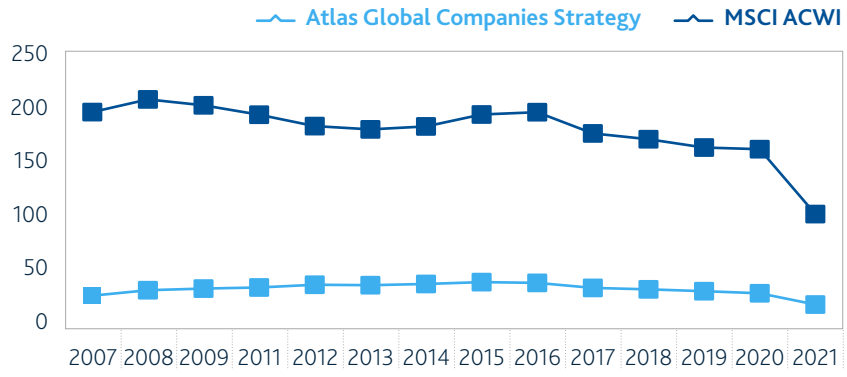


In addition, we believe that companies that better manage and nurture their environmental, social, shareholder and outside stakeholder capital are less prone to destroy financial value over the long term. Thus, the energy transition and the broader encapsulation of ESG considerations, is inextricably linked with our stated investment objectives of stable, long term value creation and these considerations are incorporated into our assessment of each wealth creation pillar where relevant.

What this results in is a portfolio of companies that we would believe to be exceptional i.e., companies that we feel can be relied upon to increase their intrinsic value, year in year out, persistently and consistently, and for a long period of time. But at the same time, the resulting portfolio is well aligned to a low carbon world. This does not only mean that they are low carbon emitters by nature of their business model, but many of our companies offer products and services that are mission critical enablers of the planet achieving its net zero ambitions. In this next section we will profile a number of these companies.

Fiera Atlas Global Companies Strategy is committed to mitigating climate change with our support of the Net Zero Asset Managers (NZAM) initiative. The NZAM initiative commits to investing aligned with the goal of reaching net zero greenhouse gases emissions by 2050 or sooner. The team analyse all existing and prospective portfolio companies to evaluate their climate impact and their GHG emissions reduction policies. Our commitment to mitigating climate change also serves as our environmental promotion under the European Sustainable Financial Disclosure Regulation. The Atlas Global Companies Strategy is compliant with Article 8 SFDR.

Weight average carbon intensity trend of current holdings



Source: MSCI as of 31 December, 2022.

Atlas company examples

The Atlas Team believes that the most important input to delivering upon our long-term objectives for our clients is always the quality of the underlying companies themselves, a characteristic that we will never compromise on. Diversification is an essential second stage of effective portfolio management.

We seek to invest in exceptional companies that earn their income from different sources of end demand, different growth paths, different customers and different geographies and industries. The more idiosyncratic, diverse, and uncorrelated these income streams are over the long run, the greater our ability to diversify and manage risk.

The Atlas strategy invests in a selection of 'technology' companies that service a wide variety of specific industry verticals across the globe. These companies, operating across a vast array of end markets and countries, help showcase why digital transformation initiatives are being adopted so widely. They serve as critical enablers of creating new 'green' solutions as well as making more carbon intensive industries more efficient. In either case, we need to do more with less by becoming much more productive.

- Multiple studies in recent years have shown the substantial benefits of industrial companies implementing digital solutions, delivering material return on investment (ROI) benefits. BofA Global Research surveyed the evidence and found that, on average, across these studies automation and industrial software can reduce manufacturing costs by >25%, labour costs by >30% and energy use by 24%, while increasing productivity by well over 25%.[8]
- Schneider's survey of 230 customers' projects in 2021 highlighted that customers can reduce their energy consumption by up to 85% when implementing digital strategies or improve their productivity by up to 50%.[9]
- The World Economic Forum in partnership with McKinsey Institute found that implementing digital transformation across manufacturing facilities can result in c25% reduction in energy costs, >30% reduction in labour costs and close to 30% reduction in manufacturing costs.

Within digital transformation, we have selected a handful of the best enterprise solutions providers which benefit from strong longstanding relationships with their customers, high barriers to entry / exit, longer and more predictable product cycles, lower regulatory risk, greater potential to add additional value to their customer through additional product innovations, and they are increasingly moving towards a recurring revenue model which helps improve the stability of cashflows. We would argue that the end market demand drivers for our technology companies are quite broad, whilst their highly resilient and recurring cashflows are extremely different to the more cyclical cashflow streams in the more consumer facing and advertising driven parts of the technology landscape which dominate the indexes.

Aspen

Aspen is a leader in the **energy and mining** sectors offering asset optimisation systems that help capital-intensive companies with asset design, operations, and maintenance of complex projects over the full life cycle, often 30 years or more. It enables those companies to develop more efficient processes and clean methods of energy production.

Example:

CEPSA used AspenTech when expanding its highly complex hydrogen facility to minimize hydrogen losses and reduces CO_2 emissions by optimizing the refinery operations, resulting in thousands of tons of carbon dioxide being saved from release into the atmosphere along with delivering substantial cost savings.

Note: Specific investments described herein do not represent all investment decisions made by Fiera Atlas. The reader should not assume that investment decisions identified and discussed were or will be profitable. Specific investment advice references provided herein are for illustrative purposes only and are not necessarily representative of investments that will be made in the future.

8. BofA Global Research, "Transforming World: The Digital Industrial World" (12 December, 2022)
9. https://blog.se.com/buildings/building-management/2019/02/12/where-is-the-evidence-that-digitization-is-indeed-working/ (December, 2019)

Bentley Systems

Bentley Systems operates within the **infrastructure engineering** segment with entire life cycle solutions in areas such as roads, bridges, railways, buildings, power plants and utility networks. Bentley's tools are used to empower engineers to create more sustainable infrastructure essential to ensuring a more resilient, reliable, and redundant future energy system.

Example:

Sterlite Power Transmission used Bentley systems to optimize delivery of reliable renewable power, including a substation and transmission lines to generate power to 30 million residents in North East India. The project set a new benchmark for renewable project delivery in the area, saving a total of INR 1.1 million in resource hours and reducing the schedule by over a month.

Autodesk

Autodesk is a provider of software solutions primarily to the **construction** market. The buildings and construction sector accounts for nearly 40% of the worlds energy use and process-related carbon dioxide (CO_2) emissions and approximately 30% of site waste is sent to global landfills. As one of the worlds least digitised sectors, Autodesk is in a great position to help architects and engineers to design more energy-efficient buildings, both new and existing.

Example:

Mills Group used Autodesk's Revit building design software and Autodesk Insight building performance analysis software to design a netzero residential project, requiring architects to test many assumptions about building techniques, materials, and lighting. Similarly, when Microsoft needed to construct 17 new buildings and 2.5 million square feet of new workspace, it employed Autodesk's tools to help it minimize the project's potential climate impact, including reducing the campuses embodied carbon by as much as 30%. Microsoft has a goal of being carbon negative by 2030.

Ansys

Ansys provides high performance simulation modelling for product innovation across a variety of industries including **aerospace and automotive**. Ansys is used by engineers at the world's largest companies to design and develop products rapidly and efficiently, enabling them to see how their ideas will perform against millions of variables, and resulting in performance improvements, energy efficiency gains, and cost savings alongside reduced product development lead times compared to the alternative of physical prototyping.

Example:

Ansys simulation solutions empowered Atomberg, a high-efficiency fan and small appliance manufacturer, to develop a more energy-efficient electric fan motor. The result is a smarter, more sustainable and streamlined internet-of-things (IoT) enabled ceiling fan design that consumes 65% less electricity than conventionally powered fans. ABB research suggests motors account for 45% of the world's energy usage.[10]

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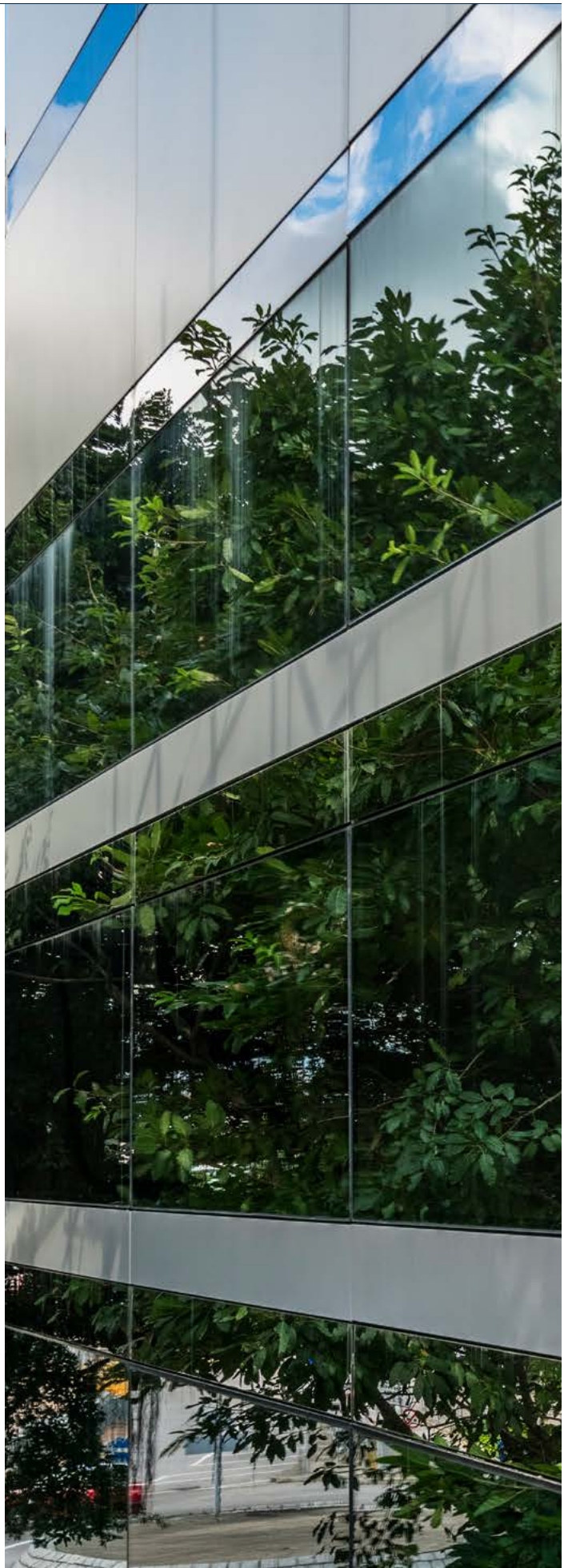
10. https://new.abb.com/news/detail/90692/new-survey-reveals-global-industry-is-accelerating-investment-in-energy-efficiency (February, 2022)

Conclusion

For the Atlas Global Companies team, the energy transition is one of many structural growth and ESG considerations that are evaluated as part of an investment case. However, as we have outlined an interesting investment theme, it is not enough on its own to warrant an investment. It is only when the combined forces of high profitability, low capital requirements, and structural growth convene at reasonable valuations does long-term shareholder value creation become an inevitable outcome. Companies that can be relied upon to continue to grow their intrinsic value over time will be worth more tomorrow than they are today.

We believe we are well placed to weather the current near-term economic uncertainty given that consistent above average shareholder value creation and expansion is the best protection against inflation, lower growth, recessionary pressures, and less plentiful capital. In the long term, we also believe that being firmly on the right side of and positively aligned to one of the most important transitions in the global economy over the next 20-30 years will help us in our endeavours to deliver upon our commitments to our investors.



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