

# Sustainable Investing

**ADDENDA**

**CAPITAL**

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## Sustainable Investing Illustrated: Case Studies and Examples

Addenda Capital's approach to sustainable investing is guided by the principles that paying attention to environmental, social and corporate governance (ESG) issues will help us provide better investment outcomes for our clients and that our investment activities should promote sustainable development. There are three pillars which support our sustainable investing activities: the promotion of sustainable financial markets, the integration of ESG factors and stewardship. By formally integrating analysis of ESG risk factors and opportunities into each investment process, we get a more accurate assessment of business risks and growth prospects. The stewardship we provide by monitoring and engaging with investee companies encourages them to optimize their long-term value creation while dialogues with regulators and policy makers encourage greater integrity in our financial markets and promote their long-term sustainability.

*Insightful research: the key to our expertise*

About five years ago, we embarked on the difficult task of translating our sustainable investing principles into practical investment practices in a manner that is consistent with our continuous improvement and execution of our existing investment processes. A key aspect of our approach is the explicit integration of ESG issues into our investment decisions. We do not reduce our investment universe by screening out industries or business practices for ethical reasons – we rather enhance our investment decisions by considering ESG factors that could have a material impact on financial or investment performance.

Implementation of ESG integration rests with each investment team as Addenda Capital offers a comprehensive array of investment strategies across a broad range of asset classes and responsibility for investment decision making is distributed accordingly. Each team is supported by the Sustainable Investing team. Over the past few years, the sector specialists in the Canadian Equity team, the portfolio managers in the United States and International Equity teams, the Fixed Income teams and in the Commercial Mortgage team have been working together with the sustainable investing team to improve our processes for proactively identifying and assessing ESG risks and opportunities in our existing investment processes. Below are some examples from these investment teams.

ESG integration is the incorporation of environmental, social and governance issues into investment analysis and decision-making processes.

### Canadian Equities: Climate Change Regulation

Our Canadian Equity team undertakes detailed fundamental company-specific research to identify and assess a company's ability to generate free cash flow that will accrue to common shareholders. They use their research to estimate the intrinsic value of a company which is then compared with current share prices during portfolio construction. Our team has been following climate change related regulatory developments for many years.

In the energy sector, oil and gas companies are going to face higher operating and capital costs related to compliance with greenhouse gas related regulations. They will also face operational issues related to changes in physical climate parameters and global demand for their products might be negatively impacted by regulatory changes and technology advancements.

Regarding operating costs, for a few years, we have been including an explicit operating cost related to greenhouse gas emissions in our discounted cash flow models for oil and gas companies operating in Alberta's oil sands. The forecasted costs for each company are a function of our estimates of their oil sands production and greenhouse gas intensity of oil sand production (tonnes of greenhouse gas per barrel produced) and our forecasted greenhouse gas related regulatory costs for the province. Our base case oil sands model has greenhouse gas costs representing 0.7% of oil sands operating costs in 2016, rising to 3.5% in 2018. Greenhouse gas costs have in turn reduced our calculated intrinsic value by 2.9%.

In addition to building operating costs into our base case, we have also tested some alternative costs scenarios. In some extreme scenarios, such as a tax of \$100 per tonne of greenhouse gas, costs can exceed \$10 per barrel produced, which naturally has a very high impact on intrinsic value calculations. By way of reference, Suncor uses cost estimates between \$15 and \$55 per tonne of greenhouse gas and has said recent costs have been in the range of \$12 and \$18 per tonne.

## US Equities: Organic and Natural Food

Our US Equity team, in addition to a fundamental bottom-up analysis, employs themes to better understand and evaluate companies' growth prospects. One theme that has become significant in the consumer staples sector is organic and natural food. At a recent industry conference, the majority of food products companies addressed and even focused considerable portions of their presentations on this issue and how they are addressing them. One company even came out and stated that they were in favour of national standards for labelling genetically modified ingredients in foods.

In considering these issues and the growth of natural and organic food from an investment perspective, our team's approach focuses on understanding and evaluating the risks to the companies and their earnings from these issues. If organic and natural food and increasing transparency are positive drivers when it comes to sustainability, then how do we invest around this theme? As with any investment, we have to understand potential investments' operating environment: How certain are we that these positive drivers will continue to result in meaningful growth? How meaningful are the barriers to entry? What does the competitive landscape look like and how certain are we that they will be able to continue to capture at least their share of that growth? Is management's strategy consistent with what has worked in the past while addressing new challenges presented by the changing operating environment?

When it comes to organic ingredients in packaged foods, the established companies have been put on the back foot by start-ups able to start from scratch with simple, transparent ingredients lists. Transitioning existing products to simpler and organic ingredients is much more challenging. Firstly, consumers already know what the product tastes like and any changes to taste or texture may result in consumers looking elsewhere. For organic products, sourcing is an issue – many ingredients do not have readily available organic supply chains, particularly since organic in the United States entails a rigorous certification process. While this would appear to favour the smaller start-ups, the most successful of these have discovered that rapid growth has its own challenges. Annie's, who started out selling macaroni and cheese in New England, eventually sold out to General Mills voluntarily after finding itself unable to cope with their rapid growth.

Another consideration when addressing growth issues is the makeup of the market. Those consumers who were early to the organic products trend tend to demand more from the producers. Small producers often differentiate themselves on ideology as manifested in their products by ingredients (or missing ingredients), methods of cultivation or other means. Consumers who seek out these products often identify more completely with these ideas.

An important point to recognize however is that as these smaller brands grow, they will face increased scrutiny around how they produce their products at the same time as they start to face significant challenges around distribution, shelf life and similar issues. Can a grassroots, natural food concept scale to national scope with a large advertising budget behind it without alienating those early consumers who helped make it a success?

This seems to be bad for established packaged food companies, however it is also important to understand how consumer preferences may change as these trends become more mainstream. As transparency of ingredients becomes more mainstream, it becomes the norm and companies who do not espouse it will pay the price. Large packaged food companies are hardly holding still though. Virtually every packaged food company is already seeking to address these issues through a number of means. Firstly, many have acquired smaller, natural brands (Bolthouse Farms/Campbell Soup, Kashi/Kellogg, Annie's/General Mills) and/or introduced new natural or organic brands. Secondly, with highly successful brands, efforts at reformulations to remove artificial ingredients and colour are progressing. Finally sourcing of organic ingredients to launch organic versions of

well known brands continues. These efforts may be viewed skeptically by those at the vanguard of the natural food movement, but it remains to be seen whether this is the case with mainstream consumers. Now that these issues have gained critical mass, those companies not addressing them are clearly taking significant risks, but those who can address them in a timely and convincing way stand to reap the benefits.

## **International Equities: Carbon Footprint**

The International team invests in secular and sustainable industry trends through regional and global leaders, present in sustainable growth industries (minimum long-term revenue and operating earnings growth of 4-6% and 10-12% respectively), with non-commoditized business models, demonstrating strong competitive advantages, seasoned management skills, and operational leverage capabilities.

One industry trend that our team identified is temporary power solutions for industry, governments, events and private individuals. Aggreko was identified as that industry's global leader. The products and services they provide are mission-critical and the industry is supported by very attractive long-term structural growth drivers for energy demand:

- 1) Population growth
- 2) Economic growth
- 3) Urbanisation, and
- 4) Chronic underinvestment in electricity infrastructure globally

The temporary power supply market is highly fragmented with few competitive players on a global scale. Although it is easy to enter the market at a local level, it is very difficult to grow to a global company. Aggreko built its scale and subsequent market share over many years through their strong in-house manufacturing and development capabilities.

The end market growth demand, combined with the firm's competitive advantages, have enabled Aggreko to be the clear leader in its industry, enjoying an established position that drove high margins and returns and allowed the company to achieve a track record of double digit revenue and EPS growth over many years.

Sustainable growth driven by long-term structural drivers, strong barriers to entry and management's proven track-record and a compelling entry price led us to buy shares in the company for our clients.

The company, and the stock price, performed as expected for some time but eventually a few cracks started to appear in the long-term outlook. Weakness in emerging markets' economic growth and the rising cost of temporary power in local currencies (the vast majority of contracts are priced in US dollars) pressured demand and our thesis that power outages were becoming less acceptable across the world was being challenged. For instance, Nigeria, and its economy, was plagued by widespread power blackouts. Aggreko was also facing increased and aggressive competition from its main rival and the second biggest company in the industry, APR.

We held multiple discussions with industry experts and the company directly to get a better sense of the situation and what steps Aggreko would take to turn things around. Management's response to these challenges lacked clarity and conviction and left us somewhat lukewarm and our position in Aggreko was facing imminent disposal when the work on climate change and carbon footprint was initiated. Aggreko's carbon footprint is quite high, in large part because they lease their equipment, hence the greenhouse gas emissions are linked back to the company and not to the end client. This was an additional data point that made its way into our analysis and added another layer of risk to the Aggreko thesis.

After a thorough review, the position in Aggreko was exited in Q3 2015.

## **Bonds: Considering a New Corporate Bond Issuer**

Our corporate bond team's investment process entails extensive top-down macro-economic and industry analysis, rigorous bottom-up fundamental analysis, and portfolio construction that is underpinned by a risk management process fed by proprietary and external research.

When considering the purchase of a bond from an infrequent issuer, the team incorporates ESG considerations into their investment analysis. For example, the team wanted ESG information when Ventas, a United States based healthcare real estate investment trust was known to be considering a bond issuance in Canada to help finance an acquisition here. Addenda Capital's sustainable investing team sought out and reviewed a variety of available information concerning ESG issues including the company's own disclosure (for example its annual report and website), third party research for environmental and social risks, third party governance data and analysis and the company's Global Real Estate Sustainability Benchmark results which highlights the company's relative performance on sustainability issues against real estate peers. A summary of this research was provided to the corporate bond team along with an overall view that the issuer ranked average on environmental and social performance issues and that their corporate governance structures looked good.

The team incorporated the ESG information and analysis into their decision, along with a variety of other considerations including the corporate structure, management quality and liquidity. The team did not end up buying any bonds for our clients because they ended up being priced expensively for the level of risk.

## **Commercial Mortgages: Environmental Remediation**

Our Commercial Mortgage team believes that applying a sustainable investing approach that considers environmental and social factors when underwriting a mortgage and during the ongoing monitoring of investments will add value for our clients. We invest in, and manage, portfolios of high-quality commercial mortgages associated with retail, industrial, multi-residential and office properties.

It is sometimes possible for us to help finance the environmental remediation of a property while still earning an appropriate return for the amount of risk taken. For example, we underwrote a mortgage for a borrower that redeveloped an industrial property into a mixed use commercial/warehouse property. Half of the existing building was demolished and environmental remediation was undertaken involving the removal of holding tanks and some contaminated soil. The amount of funds initially advanced was based upon the value of the remaining property, the tenants and the land value less the remediation costs. Once the remediation was complete and verified through a phase 3 environmental assessment, the remediation holdback amount was released to the borrower, and then an additional advance was released when the borrower had secured new tenants. The end result was an excellent new commercial development with no remaining environmental issues.

## **Conclusion**

Environmental, social and corporate governance factors affect financial and investment performance. The examples above demonstrate that our investment teams have been integrating ESG considerations into their investment decisions. For the past few years, we have been working to improve our existing investment processes by making our consideration of ESG factors more substantial and by making use of our in-house sustainable investing team.

## Always in pursuit of added value

Addenda Capital is an investment management firm providing solutions for institutional and high net worth clients. We offer our clients expert services in a broad range of asset classes. Our mission is to add value through innovation, discipline and integrity, and to nurture genuine partnerships with our clients.

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