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A Focus on Carbon Intensity

As our investors and readers will be well aware, a thorough analysis of a company's ESG is always the first step of our specialist Emerging Markets partner, Northcape Capital's investment process. They seek companies that have sound ESG track records and practices, and this is the only one of Northcape's '8 Principles' where there is zero wiggle room – that is, they assess whether a company meets their minimum ESG standards first. Their experience over the years is that the most frequent reason for significant loss of capital at an EM company has been due to ESG-related failures.

This information has been prepared by Northcape Capital, the underlying investment manager for the Warakirri Global Emerging Markets Fund.

Northcape believe that the intense focus on ESG has been a key factor behind their strategies' strong investment track record (and downside protection).

ISS ESG – a leading provider of independent ESG research and analysis – has just conducted its annual analysis of the Northcape EM fund's emissions. ISS ESG uses a combination of self-reported emissions data, and in-house modelling to assess the carbon emissions of more than 37,500 companies globally.

We are pleased to disclose that according to ISS's analysis, the emissions of the Northcape EM strategy are significantly below that of the benchmark. The scope 1 and 2 emissions of the Northcape EM strategy are just 13% of that of the benchmark (see Exhibit 1). Considering scope 3 emissions as well (which are harder to estimate and the data less reliable), emissions are c. 22% of the benchmark's.

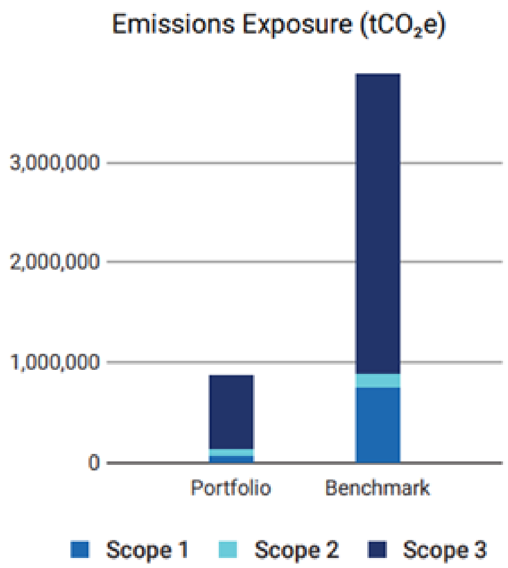
Having a lower carbon footprint is clearly desirable from an environmental perspective, but it also means that there are lower risks that such companies have will breach emissions standards, which could result in environmental fines, and increasingly in the future, carbon taxes – which will dent their valuations.

Further, it is Northcape's firm belief that the very best companies in EM care about managing their emissions because it is the right thing to do. They find such companies are invariably more resilient, and more likely to improve long-term returns for all stakeholders.

On an annual basis, Northcape review the carbon data of its portfolio and Approved List companies, and their progress towards reducing their emissions and their long-term targets. Where progress is lacking, or their long-term aspirations are unclear, Northcape engage with management and encourage them to do better.

This monitoring and engagement are very important factors behind the portfolio's much lower-than-benchmark emissions.

Exhibit 1: Northcape EM Emissions vs. EM index, 2022



Source: ISS ESG

Northcape do have some companies in the portfolio with disproportionately high emissions (relative to their revenues), which drag overall emissions intensity higher. They could simply dispose of such companies, but their first preference is to engage with management to push them to lift their game and work towards reducing their emissions.

Otherwise, the ownership of such companies will simply end up in the hands of investors who ignore the environmental impact of their holdings, do not hold management to account, and their high emissions will remain a persistent problem.

An example of this is Indocement, Indonesia's second-largest cement producer. The manufacturing process of cement creates significant CO2 emissions, but it is also one of the most difficult to abate. Northcape has engaged extensively with Indocement on its GHG emissions and targets.

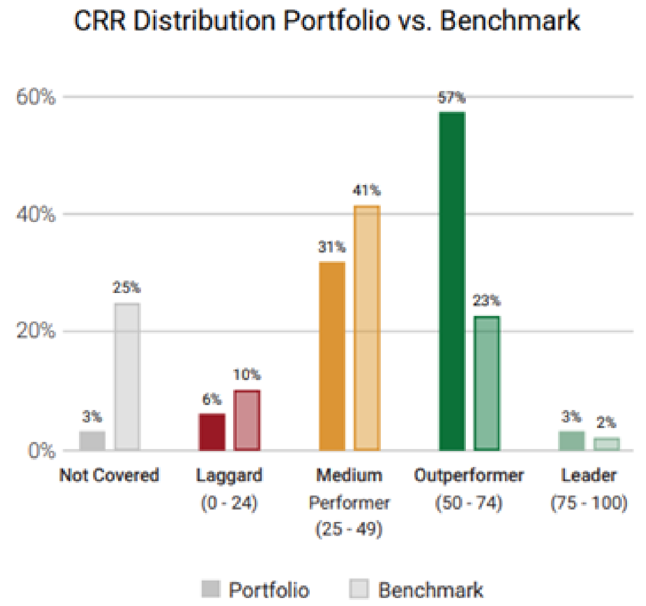
In 2022, Northcape visited the company's main facility near Jakarta to see first-hand the steps Indocement is taking to reduce its emissions. They welcomed initiatives the company is undertaking to reduce its emissions and support the long-term targets the company has introduced as well as increases in alternative fuel usage, significant Scope 1 reductions and increased volumes of their environmentally friendly product, Hydraulic Cement replacing OPC Cement.

Another factor driving Northcape EM's low emissions is that (with Indocement aside) they do not typically invest in most of the highest emitting sectors such as mining and oil & gas.

This is not simply because such industries are high emitters, but companies in these sectors do not generate high returns on capital or have the predictable earnings that they seek. Such businesses are simply inconsistent with Northcape's framework of owning high quality companies, with sustainable competitive advantages, that they expect to own for at least five years and ideally longer.

ISS ESG's report also analysed the Northcape EM strategy's Carbon Risk Rating (CRR), its proprietary classification, which assesses how exposed companies are to climate risks and opportunities, and whether these are managed in a way to seize opportunities, and to avoid or mitigate risks. Pleasingly, 60% of Northcape's companies were considered Outperformers or Leaders, which is well above the benchmark's 25% (see Exhibit 2).

Exhibit 2: CRR Distribution Portfolio vs. Benchmark



Source: ISS ESG

Northcape will publish its annual ESG & Investment Stewardship Report for 2022 later this month. More details of their extensive engagement with companies, including Indocement will be disclosed in this report.

For more information, please contact us on 1300 927 254 or visit warakirri.com.au