Carbon Emissions – An Investor View

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2020 saw an increase in investor intent and forward assessments of how climate change will impact investment decisions and the value of businesses. The Bank of England has taken this a step further by undertaking an impact assessment on selected businesses to see how they would withstand adverse climate change scenarios. The most significant entrant to this debate was Larry Fink, CEO of Blackrock who has endorsed the view that climate change will affect investment decisions.

The investment view matters for both established and growing businesses, with carbon emissions increasingly a key factor for investors, who have started to drive more disclosure and action from companies in Environmental and Social Governance (ESG).

Large miners, power generators and heavy industry are clear candidates for reduced investment and many investors plan to avoid sectors like these, as well as oil and gas. Just because the investment community has joined governments in appreciating the need for climate change mitigation, does not necessarily mean an immediate sea change. Progress may be gradual in some areas, outside the obvious targets of heavy fossil fuel extraction and combustion. The future-gazing on climate risk is mostly at the stage of identifying multi decade risks and how these will materialise. To get a fuller picture of how investors may react its worth looking at the key impacts from climate change and its mitigation.

Physical risks are topical as these are forecast to increase. These include natural events including flooding, storms, hurricanes and bushfires, which are already having an impact on the profitability of insurers, but maybe not construction. Flooding based upon the higher end of forecast sea level changes could eradicate factories and infrastructure with direct consequences for business investment and disruption.

Governments are agreed on the need for ever more stringent targets and coordinated action on expected climate change impacts. Policy is and will continue to evolve to support these targets where technology or behavioural change is not delivering the required results. This will most likely see an introduction of direct taxes on higher emitting sectors, moving beyond the framework of allowances/cap and trade that exists at an EU level. Government studies in aviation show that the instrument of demand limitation is central to delivering targets that are now legally binding on UK Government. To achieve this in an area like aviation will require reduced/arrested airport expansion, tax on frequent flyers and a range of actions to limit passenger demand. Other sectors may see similar attempts to limit demand.

In the UK, policy announcements have been made on the sale of diesel/petrol cars, even if they are absent a coherent and detailed plan, and subsidies are already used to encourage lower polluting energy generation and electric vehicles. These affect the medium term outlook for traditional vehicle manufacturers and provide opportunities that this new landscape will bring for new technology and zero emissions transport.

Investment will follow the likely winners and avoid the likely losers. The next few years will see policy directions that could be confusing as the wider reality of climate change business risk gradually asserts itself. HS2 is an example of improving infrastructure to improve transport links and reduce emissions, but this is mostly in Phase 2 not Phase 1 which will see significant emissions both direct and indirect emissions from new construction that will not be compensated for by lower operating emissions.

Consumer sentiment will also create risks for businesses that will affect investment decisions, either directly in M&A, or through share purchases in quoted companies. Consumers are increasingly concerned by the prospect of climate change and want to act to help mitigate the expected outcomes from excess emissions. Demand for products and services that are perceived to be or are actually damaging could see a reduction in demand, leading to reduced profitability and valuations. Aviation and with it the wider tourism industry carry significant risks, from both increasing popular unease with flying impacts and the wider view of aviation as being on a par with oil and gas producers.

Technology to reduce emissions will allow some respite for high risk sectors, like aviation, if it can be developed and deployed fast enough. Carbon offsetting as a primary action may work in the immediate short term, whilst opening up longer reputational/brand risk as this sector underdelivers. Investors will need to form a view as to the sustainability of corporate targets and the robustness of any plan that is communicated to prospective investors by companies.

Using ESG framework analysis from companies is supporting the creation of ethical and sustainable investment funds, rewarding the best performers. In the absence of detailed carbon impact analysis rooted in current emissions performance and reduction plans, the non emissions elements of the environmental performance and the wider social governance agenda will not fully reflect pure climate change risk.

Investor calls for action and broadcasting of the risks for future commercial activity is the start point for accelerated investor action. It may take several years to really take hold on a mainstream basis, but the direction of travel is clear. Supported by government policy and targets, the investment landscape is changing. Businesses that adjust fast and undertake both impact assessments and reduce their own emissions will be best placed to benefit from a changing investment climate.