PRI Principles for Responsible Investment

DO ESG MEGATRENDS INFLUENCE INVESTMENT DECISIONS?

Carbon risk Energy supply
Health and Safety
Energy efficiency Competition
Distributed energy generation
Cost of oil production from renewables
Energy demand Electric vehicles
Water risk
Geopolitical risk

UNEP Finance Initiative
Changing finance, financing change
United Nations Global Compact
An investor initiative in partnership with UNEP Finance Initiative and UN Global Compact

SUMMARY

During the 2013/14 PRI reporting cycle, 81% of signatories who completed the Listed Equity module of the reporting framework said that they were integrating environmental, social and governance (ESG) factors into their listed equity investments. While this indicates a strong commitment to ESG integration, it is not clear if ESG risks and drivers are being systematically valued by managers and analysts and whether ESG factors really have a material impact on company valuations.

To better understand the current state of ESG integration, we held a workshop at our 2014 annual meeting to find out which factors – ESG included – were actively analysed and integrated into valuations of energy companies and if these valuations were impacting investment decisions.

We found that even though investors acknowledge environmental megatrends in the sector – including carbon risk, competition from renewables and geopolitical risk – ultimately, the biggest impact on valuation models are still the traditional profitability drivers. However, participant recognition of megatrends for the sector seem to indicate that environmental factors will have a stronger influence on valuations in the near future.

THE WORKSHOP

At the PRI in Person annual meeting in Montreal, we gathered over 130 investment professionals to discuss the megatrends affecting the energy sector and the key factors that are being priced into their energy company valuations. The participants were divided into discussion groups, and given a presentation on the energy sector, a presentation on the risks and drivers of oil and gas (O&G) companies, and the following four questions:

1. What are the global megatrends affecting the energy sector?
2. Are the strategies of oil majors compatible with the global megatrends you have identified and with the world's evolving energy mix?
3. Which key factors would you integrate into the valuation of the hypothetical O&G company and why?
4. Would you invest in the hypothetical O&G company?

For Question 3 and Question 4, the participants were asked to provide responses based on the following hypothetical O&G company:

- A listed pure play O&G company.
- Current production breakdown: 70% conventional O&G; 25% unconventional O&G; 5% renewables.
- Company strategy: due to depleting conventional O&G reserves, 90% of future capital expenditure will be on unconventional O&G assets and 10% of future capital expenditure will be on renewable energy assets.
- Current production cost is $80 per barrel.
- Current oil price is $92 per barrel; IEA-projected oil price for 2020 is $118 per barrel.

Their responses have been outlined in the next section.

THE FINDINGS

At the time of the workshop, oil majors were feeling the pressure from investors, who had been asking them to curb their capital expenditure and return more cash to their shareholders[1].

The oil price was $93 per barrel and falling, and the market consensus was that oil prices would continue to fall in the short term.

The oil price forecast by the International Energy Agency (IEA) was that the oil price will be $118 per barrel in 2020, with the long term global demand for oil rising due to the increasing demand from emerging countries outpacing the declining demand from the West.

Figure 1: The graph illustrates the decline in oil production of oil majors since 2005 while their capital expenditure has risen. Source: Bloomberg via Astenbeck capital Management.

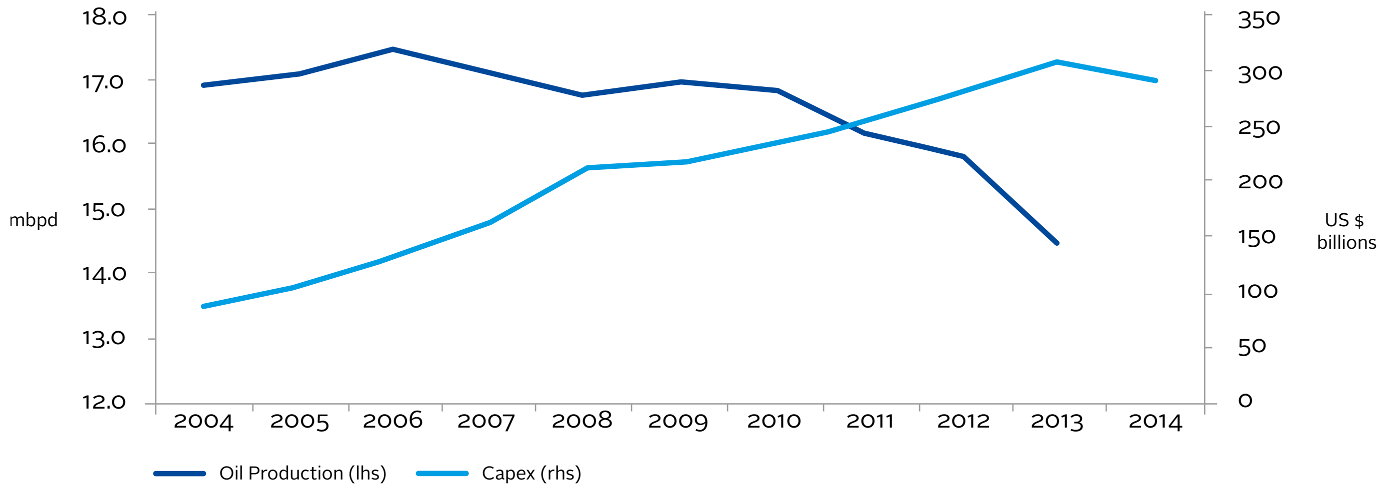
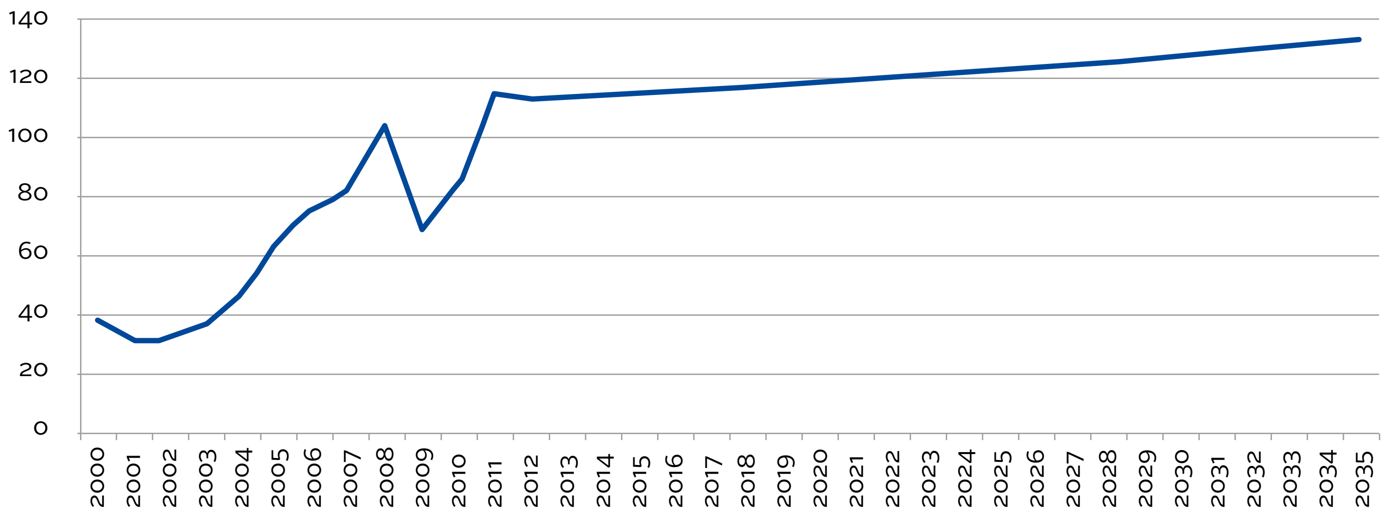


Figure 2: A graph of historical Brent oil prices between 2000 and 2013, with IEA projections under base-case scenario from 2013. Source: IEA, 2013 World Energy Outlook (© OECD/IEA).



1 Guy Chazan and Ed Crooks, 2013. Oil majors under pressure to curb spending [online]. FT.com. Available from: http://www.ft.com/cms/s/0/d3d1c5d2-4533-11e3-b98b-00144feabdc0.html#axzz3E1Wh6Naj

QUESTION 1: WHAT ARE THE GLOBAL MEGATRENDS AFFECTING THE ENERGY SECTOR?

The most popular answers to question 1 were energy demand and carbon risk. Three of the top five megatrends (carbon risk, competition from renewables and geopolitical risk) were ESG themes.

All groups included at least one ESG theme as a megatrend and eight groups mentioned two or more.

Figure 3: Responses to Question 1

	Response	Number of Groups (out of 10)
1	Energy demand	8
2	Carbon risk	8
3	Competition from renewables	7
4	Geopolitical risk	6
5	Energy supply	5
6	Cost of oil production	4
7	Energy efficiency	4
8	Distributed energy generation	2
9	Water risk	2
10	Electric vehicles	1
11	Health and Safety	1

QUESTION 2: ARE THE STRATEGIES OF OIL MAJORS COMPATIBLE WITH THE GLOBAL MEGATRENDS YOU HAVE IDENTIFIED AND WITH THE WORLD'S EVOLVING ENERGY MIX?

The "no" camp said that the industry was underestimating the role of renewables and not diversifying business lines. It accused the industry of not adapting quickly enough to the higher production costs at a time when oil majors were finding less oil and their production growth was slowing.

These reasons were countered by the "yes" camp who believed that oil majors did invest to maintain production growth by diversifying into unconventional sources and by shifting production from oil to gas.

The "yes and no" groups brought in a temporal consideration by believing that company strategies were compatible with profitability in the short term but not in the long term.

Figure 4: Responses to Question 2

	Response	Number of Groups (out of 9)
1	Yes	1
2	No	5
3	Yes and No	3

QUESTION 3: WHICH KEY FACTORS SHOULD INVESTORS INTEGRATE INTO THE VALUATION OF THE HYPOTHETICAL O&G COMPANY AND WHY?

The traditional profitability drivers of O&G companies were amongst the most popular answers to Question 3 (production costs, oil price, market share/competitive position). Contrary to Question 1, where three of the top five responses were ESG themes, only one clear ESG factor featured was in the top five for Question 3, which was carbon costs.

Only one group listed two ESG factors, despite the wide recognition of ESG megatrends in the previous questions. Six groups indicated they would integrate one ESG factor and two groups would not integrate any.

Figure 5: Responses to Question 3

	Response	Number of Groups (out of 9)
1	Input costs, production costs, capex	8
2	Carbon costs	8
3	Diversification away from conventional O&G (renewables, gas and unconventional O&G)	7
4	Oil price	6
5	Market share/competitive position	5
6	ESG factors	4
7	R&D	4
8	Oil price volatility	2
9	Regulation risk	2
10	Time horizon	1
11	Diminishing returns	1
12	Lifespan of assets	1

QUESTION 4: WOULD YOU INVEST IN THE HYPOTHETICAL O&G COMPANY?

A couple of reasons given for not investing were: 1) too much unconventional O&G and not enough renewables; and 2) high production costs and therefore no cost advantages versus peers.

The group who responded “yes and no” said that lots of conventional oil and gas meant they would invest in the short term, but a lack of investment in renewables meant they would not invest in the long term.

Figure 6: Responses to Question 4

	Response	Number of Groups (out of 5)
1	Yes	0
2	No	4
3	Yes and No	1

CONCLUSIONS

We set out to better understand which factors – ESG included – were actively analysed and integrated into valuations of energy companies.

The workshop revealed that while three of the five megatrends of the energy sector identified by the participants were ESG themes – including carbon risk, competition from renewables and geopolitical risk – carbon costs was the only ESG issue integrated into valuations by almost all the groups. Investors did not consider social and governance issues as key factors.

The biggest impact on the participants' valuation models are the traditional profitability drivers including: production costs; product diversification (i.e. reducing the exposure to conventional O&G); oil price and the competitive position of a company's business model compared to its peers.

However, participant recognition of megatrends for the sector seem to indicate that environmental factors will have a stronger influence on valuations in the near future. Along with carbon risk and competitiveness of renewables, the environmental megatrends energy efficiency, the rise of electric vehicles and water scarcity are debated amongst managers and analysts as future industry drivers. Although, these environmental factors are still often ignored in fundamental analysis.

Through the responses to questions on the hypothetical O&G company, we were able to ascertain that participants largely believed that the oil majors had not put in place sustainable business strategies. They believe oil majors are too exposed to conventional oil and there is not enough investment in renewables. The majority of the participants also believed that investment in unconventional oil and gas was not the right strategy.

Judging by the unwillingness to invest into our hypothetical company, it seem that investors are willing to carry through their ESG analysis into their investment decisions.

NEXT STEPS

The PRI will seek to better understand the reasons why recognised megatrends are not integrated into company analysis. If you have considered these issues already please contact Justin Sloggett and share your insights.

ACKNOWLEDGMENTS

We would like to thank Mark Lewis from Kepler Cheuvreux for presenting at the event. The graphs within this report were used in his presentation at PRI in Person, which has been made available in the Listed Equity section of the PRI extranet here.

The Principles for Responsible Investment (PRI) Initiative

The PRI Initiative is a UN-supported international network of investors working together to put the six Principles for Responsible Investment into practice. Its goal is to understand the implications of sustainability for investors and support signatories to incorporate these issues into their investment decision making and ownership practices. In implementing the Principles, signatories contribute to the development of a more sustainable global financial system.

The Principles are voluntary and aspirational. They offer a menu of possible actions for incorporating ESG issues into investment practices across asset classes. Responsible investment is a process that must be tailored to fit each organisation's investment strategy, approach and resources. The Principles are designed to be compatible with the investment styles of large, diversified, institutional investors that operate within a traditional fiduciary framework.

The PRI Initiative has quickly become the leading global network for investors to publicly demonstrate their commitment to responsible investment, to collaborate and learn with their peers about the financial and investment implications of ESG issues, and to incorporate these factors into their investment decision making and ownership practices.

More information: www.unpri.org

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The PRI is an investor initiative in partnership with UNEP Finance Initiative and the UN Global Compact.

United Nations Environment Programme Finance Initiative (UNEP FI)

UNEP FI is a unique partnership between the United Nations Environment Programme (UNEP) and the global financial sector. UNEP FI works closely with over 200 financial institutions that are signatories to the UNEP FI Statement on Sustainable Development, and a range of partner organisations, to develop and promote linkages between sustainability and financial performance. Through peer-to-peer networks, research and training, UNEP FI carries out its mission to identify, promote, and realise the adoption of best environmental and sustainability practice at all levels of financial institution operations.

More information: www.unepfi.org

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UN Global Compact

Launched in 2000, the United Nations Global Compact is both a policy platform and practical framework for companies that are committed to sustainability and responsible business practices. As a multi-stakeholder leadership initiative, it seeks to align business operations and strategies with ten universally accepted principles in the areas of human rights, labour, environment and anti-corruption, and to catalyse actions in support of broader UN goals. With 7,000 corporate signatories in 135 countries, it is the world's largest voluntary corporate sustainability initiative.

More information: www.unglobalcompact.org

United Nations Global Compact