Financing for sustainability: Risk and reward drive decarbonisation

This is the second in a series of articles exploring the findings from ***Financing for sustainability: Asia Pacific's evolving ESG market***, an Economist Impact report sponsored by Westpac. The report draws on a survey on the state of sustainable finance in the region gleaned from issuers in the US, Europe and Asia Pacific, and investors in Australia, Hong Kong, Japan, New Zealand and Singapore. It aims to understand today's sustainable finance market drivers and the potential for future growth, and provides comparisons to inaugural research conducted in 2019. This article provides deeper context to the survey results, with additional insights from major market participants.

Decarbonisation has become a significant business driver for a majority of investors and issuers in Asia Pacific and a key factor influencing growth in sustainable finance, according to Financing for sustainability: Asia Pacific's evolving ESG market. For investors and issuers alike, the drivers of net zero goals are mitigating financial and legal risks, capitalising on potential gains from sustainable finance investments, and responding to demand from stakeholders and shareholders.

The pace at which the sustainable finance market in Asia Pacific has grown over the past two years is one of the standout findings from ***Financing for sustainability: Asia Pacific's evolving ESG market***, a research report from Economist Impact. Equally remarkable is the profound attitudinal shift towards net zero that has occurred and is ongoing among corporates and investors in the region.

Decarbonisation is now critical to business as the financial and physical risks of climate change become better understood by investors and issuers alike. Both parties are actively applying strategies to bring their portfolios and enterprises to net zero, with sustainable finance an important tool to achieve this.

Almost all investors surveyed—91%—have begun decarbonising or have plans to decarbonise one or more of their portfolios in the coming year, while a large majority of issuer respondents—85%—have started to decarbonise their business, or plan to begin the process in the next year.

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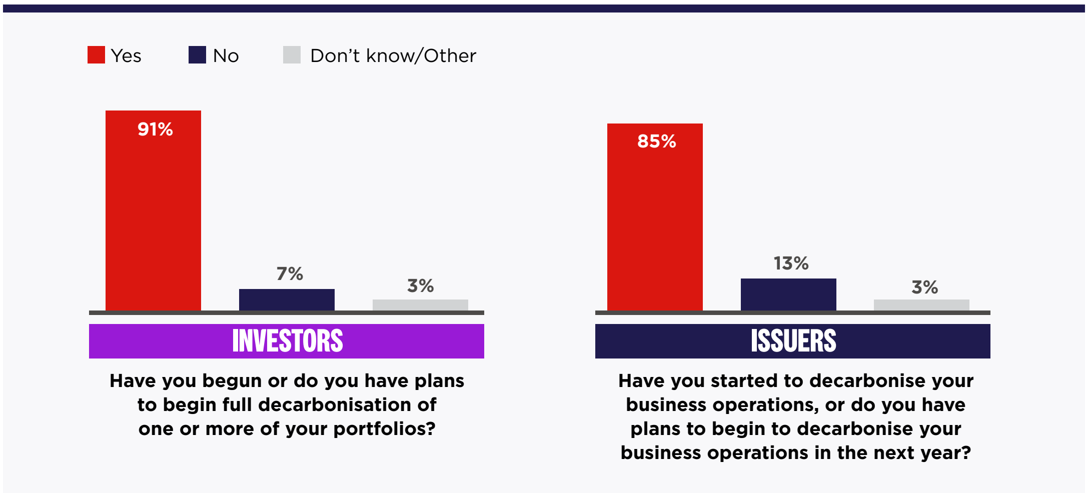
Rates of decarbonisation



Source: Economist Impact

More than half (58%) of investors who are decarbonising aim to be net zero by 2030, and a further one third are targeting 2040. Among issuers in the group, 61% aim to be net zero by 2030 and 24% are aiming for 2040.

"Decarbonisation is no longer optional," explains Kate Bromley, general manager for responsible investment at Queensland Investment Corporation (QIC). "Regardless of resource, you have to account for the full range of risks and opportunities —which includes sustainability risks and opportunities."

The net zero impact

This significant change in business priorities is reshaping financing strategies, corporate plans and the investment landscape in Asia Pacific. While ESG management and risk mitigation are strong immediate drivers of the uptake of sustainable finance, the potential for increased financial returns is also an important motivator, highlighting the vital role sustainable finance is playing in helping companies go green.

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When asked about the factors driving their use of sustainable finance, one quarter of issuers say it is to meet the company's sustainability objectives, 22% say it is to achieve financial benefits and 18% say it is to diversify their investor base.

This is reflected in the investor response as well, with 24% saying the main driver of their use of sustainable finance is improved management of ESG risk, 23% investing for sustainability or impact outcomes and 17% for enhanced financial returns.

In a clear indication of the magnitude of the decarbonisation shift among investors, Ms Bromley says QIC would look like an "outlier" if it was not pursuing net zero.

She says QIC has strategies for investing in climate solutions and energy transition opportunities, minimising emissions across portfolios, and engaging and advocating for clear climate targets at investee companies. The company's corporate activities are about to be certified carbon neutral under the Climate Active[1] carbon neutral certification program.

Its QIC Property Fund and QIC Town Centre Fund also have targets to become net zero for scope 1 and 2 emissions by 2028, and the QIC Global Infrastructure Fund and the QIC Infrastructure Portfolio aim to be net zero in scope 1 and scope 2 emissions by 2040. QIC has also committed to making active contributions to the broader infrastructure industry net zero ambitions to meet scope 3 objectives. Emissions are measured through direct capture of carbon emissions data at asset level and QIC monitor this on an absolute and intensity basis.

Mirroring the survey responses, Ms Bromley says risk mitigation is the primary driver for QIC's decarbonisation plans, with climate now ranked as a "first order risk" that is classified as separate from the risks related to ESG disclosures and regulations. Expectations from clients and stakeholders have also been a contributing factor, along with the fact that "the regulatory focus on this is rapidly increasing".

In contrast, issuers often have a more nuanced perspective, as is the case for Blackmores Group, an Australian health supplements company listed on the Australian Stock Exchange. Sally Townsend, Blackmores Group's head of sustainability, says risk has grown to become a driver of the company's sustainable finance initiatives in recent years and this has accelerated their progress, but it has been pursuing this for longer than many investors.

Ms Townsend says Blackmores had a comparatively solid ESG footing when she joined in 2002, and as the company purchased a manufacturing facility and expanded globally, its ESG sophistication has grown. It now aims to decarbonise all material impacts from its operations to reach net zero emissions by 2030.

"We feel a very strong sense of urgency to step up both our environmental and our social impact efforts, because we're already two years into what's referred to as the decisive decade, which is where countries, communities and companies have one last chance to rewire our world so that we're living within our planetary boundaries," she explains.

Sustained disruption

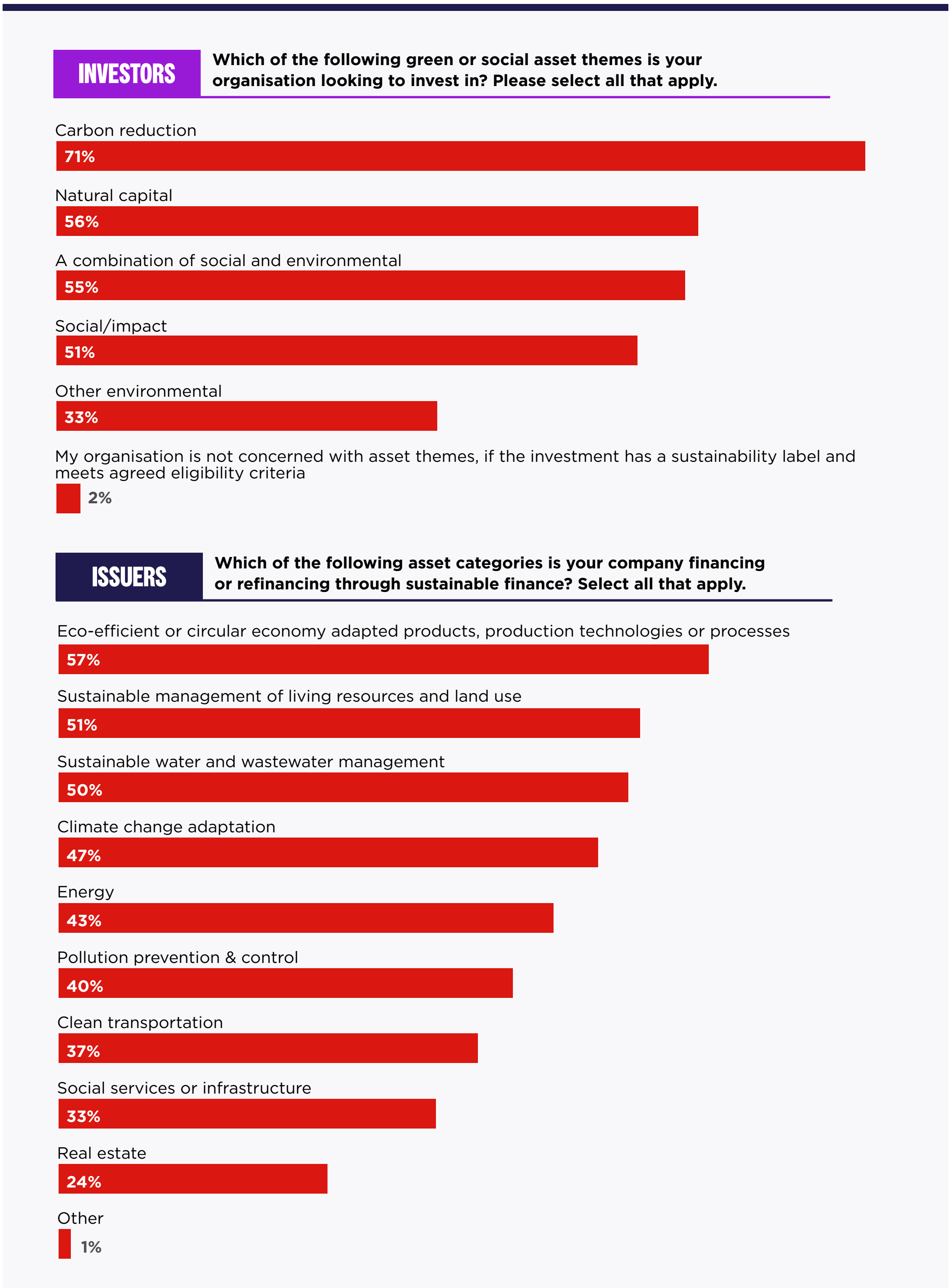
Although their drivers of sustainable finance use may differ, the process of decarbonisation can be difficult for both issuers as well as investors, especially as this is a new area for most. While numerous guidelines and consultants offer frameworks and advice, such as the International Capital Market Association, there are relatively few case studies to follow, and the approach can differ depending on the issuer's business and the asset class or classes an investor is focused on.

A myriad of green asset themes and categories are available to investors and issuers. Most investors are looking to invest in carbon reduction (71%) while a majority of issuers are planning to finance/refinance eco-efficient or circular economy-adapted products and processes (57%).

"It's a simple thing to describe decarbonising, but it can be disruptive to existing investment processes and that is being played out at the moment," explains Ms Bromley.

1 Climate Active homepage. https://www.climateactive.org.au/

Asset themes companies are looking to invest in or finance



Source: Economist Impact

Decarbonisation goes right to the heart of business, with 65% of issuer respondents saying their company's sustainability strategy now "significantly" impacts its financing decisions and 71% rating the corporate sustainability strategy of their company as "very important" to their external stakeholders.

Among investors, the centrality of decarbonisation is reflected in the comprehensive way in which they are integrating ESG concerns into existing investment decisions, with 63% using ESG integration, 62% using sustainability-themes investing, 53% using positive screening and 49% engaged in corporate engagement and shareholder action.

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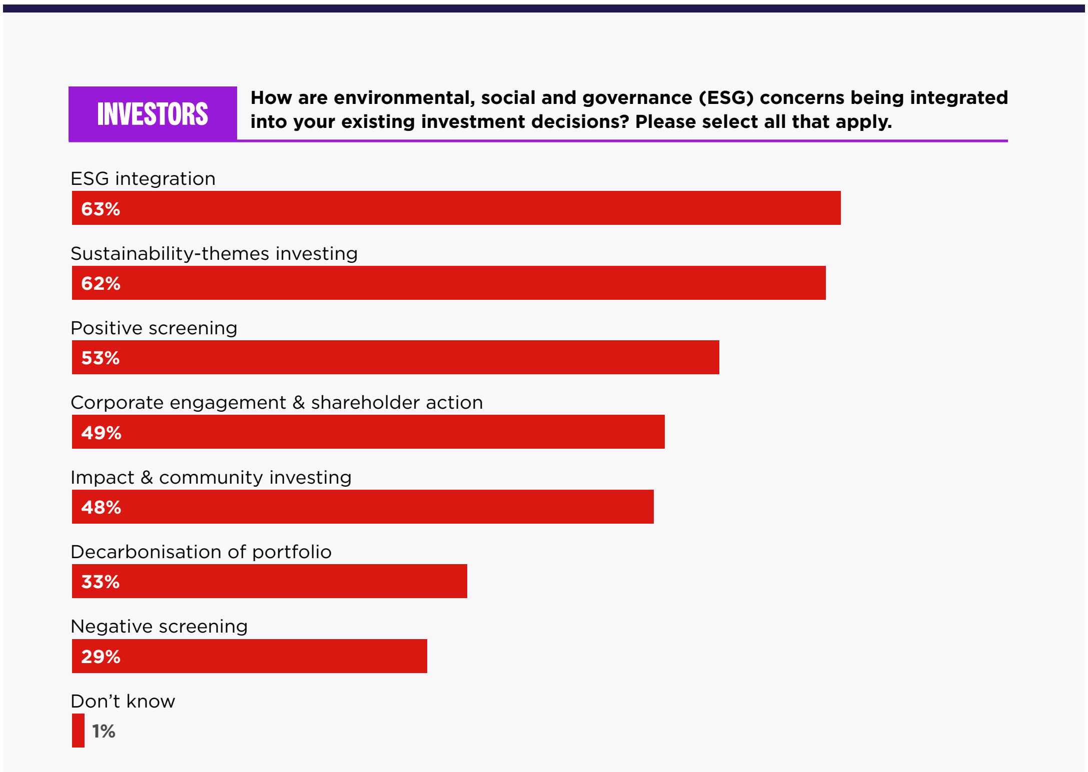
Andrew Jones, head of private debt at QIC, says decarbonisation has added complexity to his side of the business, both in terms of structures and relationships. A key priority for his team is to work closely with borrowers, to help them transition away from carbon fuels towards net zero, often with sustainability-linked pricing mechanisms that work as a carrot and stick approach.

Integrating ESG concerns into investment decisions



Source: Economist Impact

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When negotiating a private loan, for example, companies must demonstrate their commitment to a zero net emissions path through measurable targets. If they miss these, penalties in the form of higher interest rates apply. The investment decision itself also includes a review of expected improvements and efficiencies in the target business across a range of factors including improvements in the ESG profile and carbon footprint.

"We believe that improvements across the range of ESG targets build long-term sustainable value in a business and we are happy to recognise and reward this in our analysis," explains Mr Jones.

The gap that presently exists between what QIC would like to invest in, and the measurable sustainable investments that are available, can also lead to "interesting conversations" with potential companies about whether they are willing to pay the increased premiums for green investments that result from the excess demand, according to Mr Jones.

He says many are happy to trade off the increased cost for the reduced climate risk, but it can often require multiple meetings to explain why sustainable investments presently differ in pricing to traditional approaches.

"This requires detailed and in-depth conversations with clients to help them understand what we can deliver to them," explains Mr Jones, who says discussions prior to decarbonisation were much simpler. "It's something that has changed...to a lot of detail and a lot of learning from both sides as we understand what works best and what is needed."

Ms Townsend says Blackmores' journey to decarbonisation has been made easier by strong board and CEO support, but it has required time and a concerted communications effort to build an understanding across the business of what decarbonisation is, and then "delivering some level of optimism that we could effect change".

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As the business has grown and developed into more global markets, the company has also had to expand its ESG efforts. This has involved identifying how Blackmores can decarbonise all aspects of its business, and ensuring it has a sustainable and ethical supply chain.

"So in the last few years, we've really refocused to putting out some very big public targets that are aligned to our most material impacts. We know that our progress depends on how deeply we embed our goals, right through our organisation," Ms Townsend explains.

"For us, it's been about having the right balance between developing culture and having a clear governance framework to support our sustainability vision, while at the same time, sustainability-linked finance is something that increases...accountability of our sustainability goals across the business."

Read the full report and details of research methodology on Westpac IQ.