Sector analysis

Sustainability

ESG integration

Case study: energy sector

Oppertunities and risks

Application in portfolio management

Future viability

Union Investment

ESG integration in practice: sector analysis based on sustainability criteria in portfolio management

December 2019

Deep ESG integration through standardised sector analysis

Sustainability is an increasingly important topic – not just in the political and public debate, but also for the valuation of companies for investment purposes. The influence of environmental and social standards and principles of good corporate governance on the valuation of companies is steadily increasing. In light of this trend, ESG integration has become a buzzword among asset managers. But what does it actually mean? How do you integrate ESG criteria?

Identifying ESG risks for companies or sectors at an early stage and seizing investment opportunities arising from a sustainable and future-oriented positioning

In order to exploit the findings of a comprehensive ESG analysis in the best possible way, ESG analysts and portfolio managers need to collaborate as closely as possible. In other words: The traditional fundamental analysis needs to be enhanced with ESG components! This approach aims to achieve two objectives: To identify and assess ESG risks for companies and sectors at an early stage and to take advantage of investment opportunities arising from sustainable and future-oriented business models.

Corporate data and systematic analytical processes are standard elements of a professional company assessment. In addition to SIRIS, our continually expanding proprietary ESG database, equity portfolio managers at Union Investment can now also access ESG sector templates. These templates provide a standardised analysis matrix. ESG analysts and portfolio managers add up-to-date ESG information to this matrix on an ongoing basis. These comprehensive sector analyses deliver additional ESG-related insights into individual market segments. The opportunities and risks documented in these analyses are an important part of the foundation on which the investment decisions of Union Investment and its intensive engagement activities with investee companies are based. The easiest way to gain a better understanding of the process is to take a closer look at the 'mechanics' of the process and some illustrative findings.

Closer collaboration builds trust

In addition to ESG factors that have an impact at the level of individual securities, indications at sector level are also very relevant when it comes to constructing portfolios and picking stocks. The United Nation's 17 sustainable development goals (SDGs), for example, can be used as input in order to identify particularly promising investment ideas. For example, companies from subsectors such as solar and wind power as well as 'green buildings' play a key part in slowing climate change. These segments are therefore particularly interesting for investors at the moment.

There are 13 sector templates in total and they all use a common underlying structure. But each also takes account of the special characteristics of its particular sector. Figure 1 below clearly shows that the financial implications of issues in the three ESG dimensions can vary significantly in scale depending on the sector.

The energy, materials (chemicals) and utilities sectors, for example, are very susceptible to costs arising from environmental issues, whereas companies in the financial sector mostly struggle with corporate governance issues. Companies from the communications service sector (telecommunications) are vulnerable in terms of social issues, e.g. regarding data security and protection of privacy. A nuanced examination of every individual sector is therefore of paramount importance.

Figure 1 **Overview of the scale of financial implications on business models in selected sectors**

	Sub ESG	Communication Services	Energy	Financials	Materials (chemicals)	Utilities
Environment	Energy efficiency	Moderate	High		High	High
	CO_2-emissionen		High		High	High
	Innovation and transformation	Moderate	High		High	High
Social	Labour standards and human rights					
	Social responsibility		Moderate	Moderate	Moderate	High
	Data protection/privacy	High		High		
	Product safety and quality	High			High	Moderate
	Access to products and services	Moderate				Hoch
	Human capital (talent) management			Moderate		
	Supply chain management/sourcing				Moderate	
Governance	Business ethics			High		
	Quality of governance			High		
	Risk and reputation managementt	Moderate	High	High	High	
	Regulatory risks	High	Moderate	High	Moderate	High
	Cyber security	Moderate		High		

Source: Union Investment

The collection of data for the templates and the work on relevant subject areas have benefits for everyone involved. In many cases, discussions between ESG analysts and portfolio managers help both sides to gain a better understanding of the process and the results obtained.

Discussions between ESG analysts and portfolio managers enhance their understanding of the process and the results obtained

A comprehensive sector assessment can only be achieved if all sides collaborate to answer questions regarding the 'core ESG factors' – i.e. particularly important environmental (e.g. use of resources), social (e.g. upholding employee rights) and governance (e.g. corruption prevention) aspects.

Taking account of risks

Taking account of specific risks resulting from regulatory changes, technological advances or potential legal action is crucial to the formation of a well-founded assessment. Figure 2 illustrates this fact using the energy sector as an example.

Figure 2 **Overview of relevant ESG risks in the energy sector (example)**

Event risks	Regulatory risks	Litigation risks	Reputational risks	Technology risks
• The highly complex process of extracting oil and gas from remote deposits increases the risk of accidents • Politically motivated attacks on oil/gas infrastructure • Growing number of potential targets for cyber attacks	• Government requirements regarding energy mix/CO_2 emission thresholds • Politically motivated rules regarding the procurement of oil and gas • OPEC price policy	• Lawsuits against the repowering of wind farms • Lawsuits against coal mining • Lawsuits against the construction/operation of oil/gas pipelines • Lawsuits against flaring and water pollution • Drilling bans	• Coal supply chain ('blood coal' from Colombia) • Contamination of water resources • Damage caused by a rise in fracking/oil sands extraction activities	• Demand for oil and gas is declining faster than expected due to efficiency gains resulting from technological advances

Identifying opportunities

Of course, the process is also designed to help identify opportunities that arise from more sustainable practices and the adoption of future-oriented business models. For companies in the energy sector, for example, it pays to reduce water and electricity consumption.

Figure 3 **Overview of ESG opportunities in the energy sector (example)**

Health	Education	Clean water	Renewable energies	Social sector
Energy efficiency	Sustainable transport	Green buildings	Sustainable consumption	Environmental protection

Renewable energies

Expansion/use of wind, solar and hydro power plants and energy storage solutions

Use of gas-fired power plants instead of coal-fired power plants as an interim solution and as back-up capacity

Increasing forward integration (growing levels of upstream activity)

Energy efficiency

Use of fuel cells, cogeneration systems, district heating

Green buildings

Distribution network suitable for decentralised, building-integrated power generation

Provision of electricity, charging points or vehicle fleets (= energy storage) to support electric-powered transport

Clean water

Fresh water supply, water treatment, waste water disposal; efficient use of water. Reduced use of chemical additives

Environmental protection

Recycling and waste management Switching off flaring facilities

Next-generation biofuels

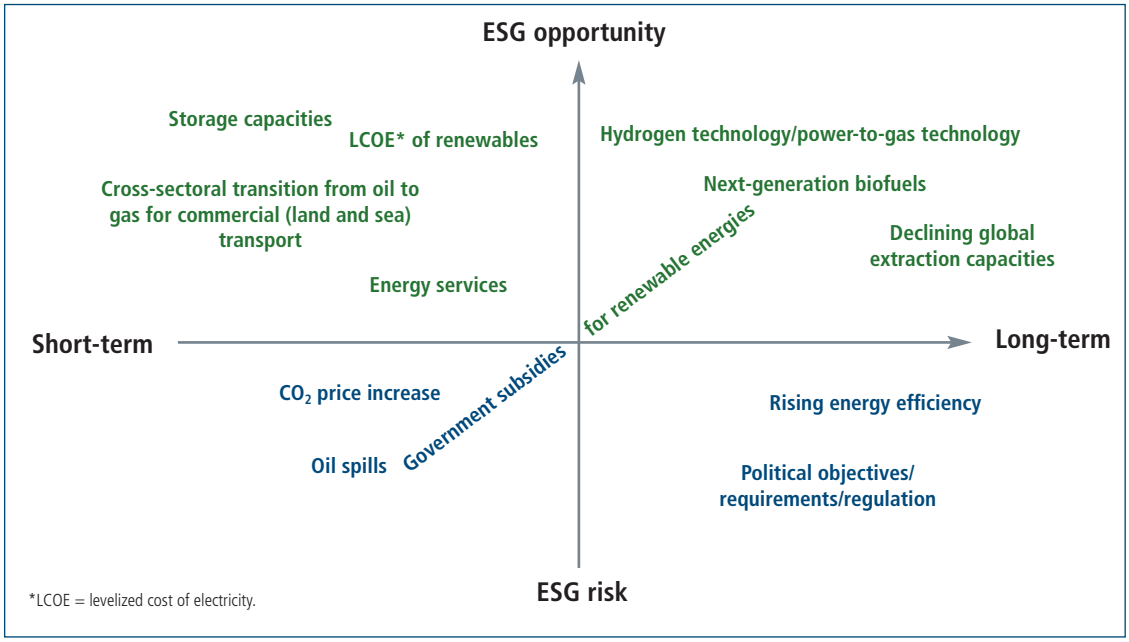
Social sector

Security of supply, affordable energy

Source: Union Investment

The format best suited to illustrate ESG opportunities and risks and to convey the positioning of different ESG factors relative to each other on a time scale is a quadrant chart. Discussions about the 'correct' positioning of aspects on charts such as figure 4 can often help everyone involved to gain a deeper understanding of how the findings of such analyses could be used for investment decisions.

Figure 4 **ESG responsibility – more than just a risk**



Source: Union Investment

Based on the documented opportunities and – above all – risks, portfolio managers and analysts also receive prompts regarding potentially critical engagement issues to be addressed with companies in the relevant sector. Questions regarding supply chain controls, resource management and controversial business practices are of particular relevance in the context of engagement activities.

Practical application in equity portfolio management

Timely availability of background information

The individual sector analyses also include an overview of major companies from the sector that are represented in Union Investment's portfolios. Recent comments from portfolio managers and ESG analysts on potential controversies and business trends – from a fundamental and a sustainability-oriented point of view – complement this overview. After all, finding out about the latest controversies and regulatory changes as early as possible is of particular importance for portfolio managers because such events can have a significant impact on the performance of individual companies or even a whole sector.

The following example can be used to illustrate this innovative combination of ESG-related sector information and investments in individual securities: From an ESG perspective, the oil and gas industry should be treated with caution (think 'stranded assets' and 'carbon footprint'). Compared with other equity market segments, the prospects for this entire sector can be described as 'substandard'. In truth, you can find both 'black sheep' and a few 'gems' in the energy sector. Some companies specialise in the extraction of oil from oil sands. This crude oil production method is highly complex, very costly and not very sustainable. Historical data since 2011 shows that North American companies from this subsector have been performing less well than the oil sector as a whole. And over the same period, both segments have delivered a weaker performance than the overall US market as measured by the S&P 500.

This scenario shows that ESG analysis can help to filter out 'black sheep' both at sector level and within sub-segments.

But there is also a counterexample from the same sector, this time based in Europe: Historically, the Finnish company Neste Oyj was considered a traditional oil sector company, with operations in oil extraction and processing and the sale of oil products. But around the end of 2010, the company started to place a stronger focus on its renewable energies segment. Neste decided that, going forward, it would invest more heavily in research and development with the aim of developing oil derivatives that generate much lower carbon emissions during the combustion process than other comparable fuel types. Its investment and innovation efforts clearly paid off both for the company and for investors: Since 2011, the company has been outperforming the oil sector by quite a margin.

ESG sector templates offer useful indications regarding risks that could have a lasting impact on the performance of an entire sector.

In terms of practical application, this demonstrates that ESG sector templates and the results from sector analyses contained in them can provide important indications and flag up risks (see figure 2) that could have long-term implications for the entire sector.

But the analyses can equally highlight subsectors, individual companies or innovative trends that might offer promising investment opportunities in an otherwise challenging industry (see figures 3 and 4).

Our new ESG analyses should thus deliver added value for investment decisions, not least in combination with SIRIS.

Conclusion and outlook

General awareness of the importance of ESG factors and their impact on portfolio management has increased further as a result of the joint ESG sector templates project. This promotes our ongoing process of ever deeper integration of ESG criteria into the fundamental assessment of equities. In future, there should be regular updates and reports on individual sectors which will help us develop particularly promising and relevant investment ideas. ESG sector analyses thus constitute another useful component that enables us to identify high-level changes, risks and opportunities and to take account of these in our investment decisions. But ESG integration will not remain exclusive to the asset class of equities: We already have plans in place to expand the scope of application of our templates. For the foreseeable future, ESG integration will continue to be a work in progress.

ESG sector analyses are an important element in the identification of risks and opportunities

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