



Global Value Improvers: A Value Approach to Targeting Sustainability Gains

Key Takeaways

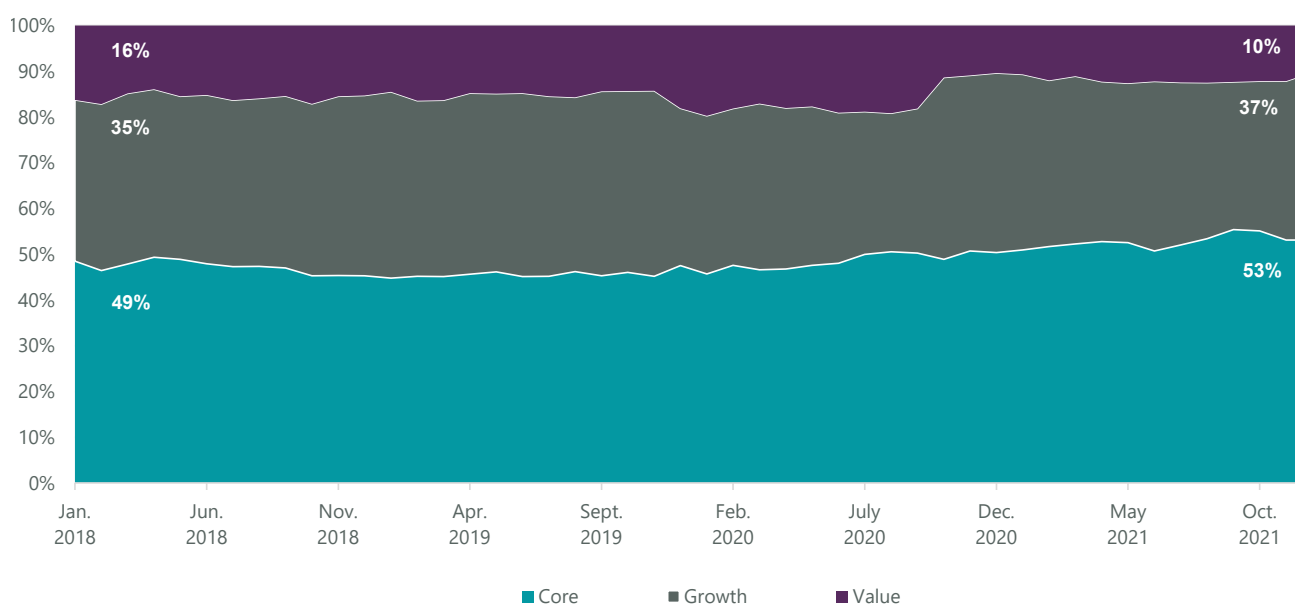
- ▶ ESG investing approaches typically focus on best-in-class companies in growth sectors, overlooking value sectors that carried poor sustainability profiles in the past but are today undertaking powerful new initiatives for improvement.
- ▶ We believe an ESG strategy targeting improvers across global markets offers greater appreciation potential compared to best-in-class ESG portfolios and can serve as a compelling complement to both traditional ESG approaches and investors' overallocation to domestic growth stocks, while also enabling shareholders to participate in sustainability gains.
- ▶ The ClearBridge Global Value Improvers Strategy integrates a value investing approach with forward-looking ESG analysis to identify undervalued companies where ESG progress can drive alpha over a full market cycle.

Value Sectors Are Fertile Ground for Sustainability Improvement

The evolution of ESG investing has tended to overlook value strategies as viable investment choices. Typically, growth strategies have earned higher ESG ratings relative to their value peers. Companies in the information technology sector, in particular, are among the largest holdings in ESG strategies due to their development of innovations to facilitate environmental sustainability trends such as decarbonisation, electrification and the global energy transition. In fact, according to fund researcher Morningstar, the majority of ESG strategies are classified as growth or core, with only 10% being dedicated to value opportunities (Exhibit 1).

Value investors tend to find their investment universe populated by ESG laggards, particularly when it comes to environmental measures. Residing in many of the "old economy" market sectors, including utilities, materials, industrials and energy, value stocks have historically been high carbon emitters, earning the moniker "brown" as opposed to more environmentally-friendly "green" stocks.

Exhibit 1: ESG Value Strategies Are Few and Far Between



As at 1 December 2021. Source: Goldman Sachs Global Investment Research. Percent of core, growth and value funds in ESG fund universe is classified based on Morningstar’s value, core, growth scoring framework.

However, the increasing acceptance of ESG investing has proven an inflection point for many of these low-scoring companies, which are embarking on plans to better integrate ESG goals into their business models. For example:

- Utilities are using government initiatives to help fund the transition from older, coal-powered plants to more renewable sources as well as install new smart-meter technology, allowing them to drop their CO2 emissions per megawatt hour (often used as an important criterion for ESG screening filters).
- Steelmakers, often at the bottom of ESG metrics due to high emissions and coal usage, are increasingly investing in smaller, steel recycling electric arc furnaces, which produce approximately 75% less carbon emissions than traditional blast furnace facilities.³
- Industrial manufacturers are also at the forefront of the development of precision agriculture, which uses sensors, tractors and even satellites to help farmers produce food in an environmentally and socially responsible way. With 40% of the world’s land used for food production,¹ the use of precision agriculture to help manage and minimise nitrogen fertiliser waste and reduce carbon emissions is helping to foster long-term sustainability while maintaining the output necessary to feed a growing global population.

While the “E” in ESG often takes center stage, many companies are also seeking to turn their social and governance practices into positive catalysts. For instance, a 2019 analysis by McKinsey showed that companies with greater gender diversity on their executive teams were 25% more likely to have above-average profitability than companies with little or no diversity, and companies with more than 30% or more women executives were more likely to outperform companies with lower percentages.² Although these criteria can be harder to directly measure, the benefits of companies seeking to improve their standing often helps to bolster corporate resiliency, reduce potential risks posed by new regulations and create greater incentives to align corporate strategy with society’s broader ESG initiatives.

We believe capitalising on catalysts for change in these traditionally lagging sectors can offer investors economic and societal rewards as they participate in companies’ transformation into more sustainable businesses.

ESG Improvers Offer Compelling Investment Opportunities

Improving sustainability profiles across traditional value sectors represents long-term return drivers we believe are not yet captured in their current share prices. According to Deloitte analysis in 2022, companies that have demonstrated an initial improvement in raising their ESG score, on average, increased their EV/EBITDA multiple

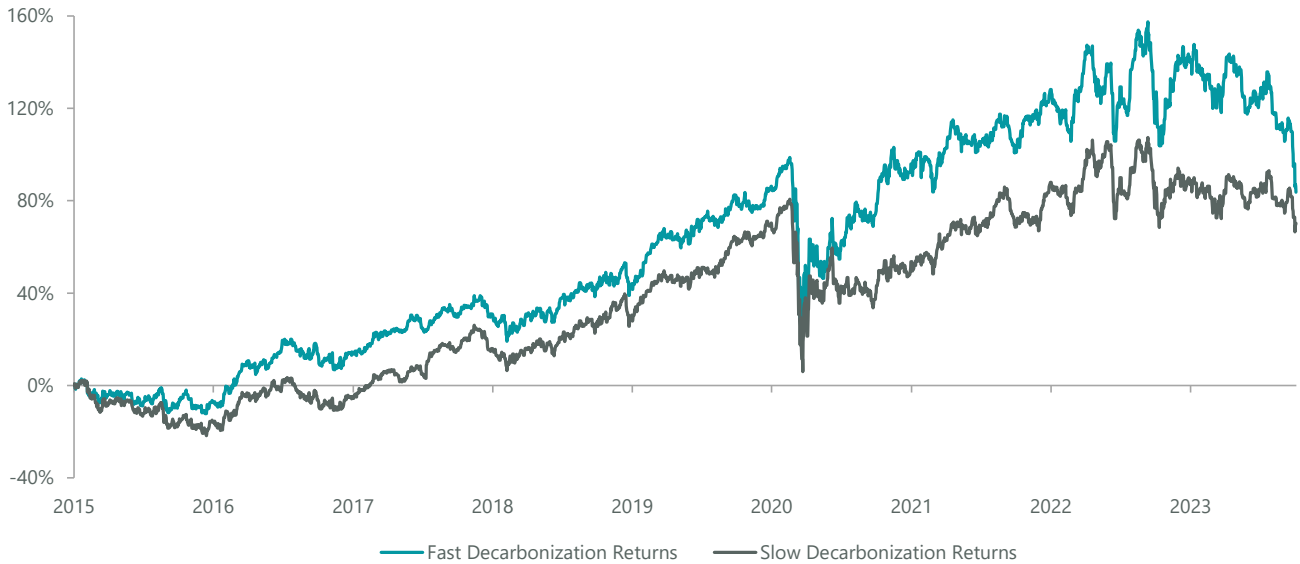
1 Environmental Defense Fund, Precision Agriculture.

2 McKinsey & Company, “Diversity Wins: How Inclusion Matters,” 2020.

3 CRU Consulting “Emissions Analysis Executive Summary Prepared for the Steel Manufacturing Association” 2022.

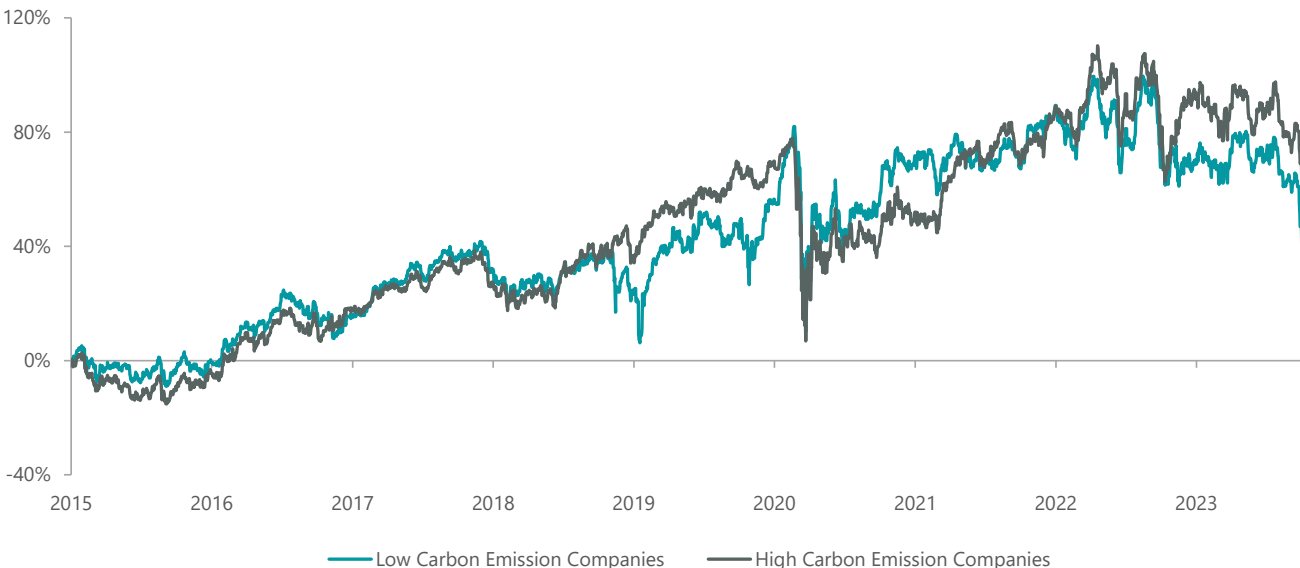
by approximately 1.2x.⁴ Companies with a faster pace of decarbonisation, which better describes improvers than their more decarbonised peers, have shown greater return potential compared to companies whose carbon intensity is changing at a slower pace over the past decade. The gap between these two cohorts has widened substantially over the past three years (Exhibit 2). Similarly, over the same period, high carbon emitters have generally outperformed lower carbon emitters (Exhibit 3). As a result, we view ESG improvers as presenting several advantages versus traditional, best-in-class ESG companies.

Exhibit 2: Faster Decarbonisation Shows Greater Returns



As at 6 October 2023. Source: Bloomberg, ClearBridge Investments. Decarbonisation rates are based on expected rates of decarbonisation estimated through 2025. Companies comprising the fastest decarbonisers include AES, EIX, PEG, XEL, CNP, AEP and NEE. Companies comprising the slowest decarbonisers include PPL, FE, DTE, NRG, SO and ETR.

Exhibit 3: Total Returns of High vs. Low Carbon Emission Companies



As at 6 October 2023. Source: Bloomberg, ClearBridge Investments. Companies comprising the lowest carbon emission group include AGR, PCG, AQN, PEG, NEE, EIX and D. Companies comprising the highest carbon emission group include AEE, FE, MGEE, PPL, DTE and CNP.

⁴ Deloitte, "Does a company's ESG score have a measurable impact on its market value?," 2022.

There are several mechanisms for ESG improvement to drive shareholder returns. Measures such as reducing waste and more effectively using electricity, for example, can have a measurable impact on a company's expenses and profitability. As a company's ESG standing rises, it can also gain access to greater pools of capital as it becomes more and more acceptable to ESG investors. Additionally, efforts to establish positive social and governance practices can generate greater shareholder satisfaction. Positive corporate governance can improve companies' long-term prospects as they become more compliant and transparent to global regulators through government-mandated ESG disclosures, particularly in regions with highly codified ESG regulations and disclosures such as Europe.

ClearBridge's Approach to Improvers in the Value Space

The ClearBridge Global Value Improvers Strategy seeks to take advantage of the opportunities offered by marrying ESG and value investing across global equity markets and focuses on investing in companies where new and emerging ESG initiatives may result in attractive total returns. We believe a dual mandate of targeting companies which are both undervalued and underappreciated for their ESG progress offers a distinct approach to sustainability investing grounded in integrated fundamental research and company engagement.

ClearBridge is an active manager with a long history of creating value for our clients while driving positive change. We expect this Strategy to continue and expand this unique value proposition as we look to have a positive impact on global companies most in need of developing greater accountability through experienced guidance.

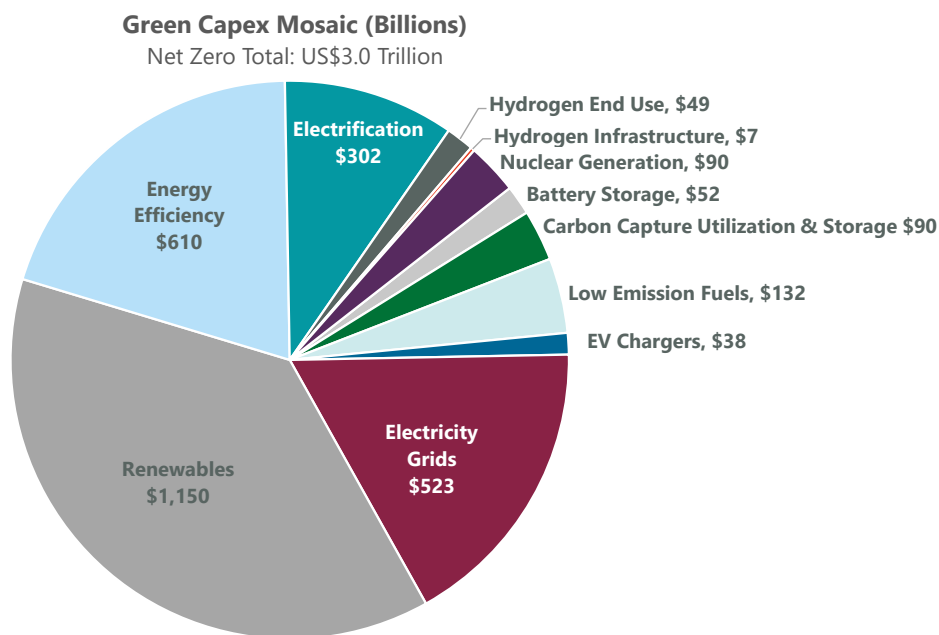
Forward-Looking ESG Analysis

ClearBridge's proprietary ESG approach and ratings system fully integrate ESG into fundamental research. ESG analysis and ratings are done by the same research analysts and portfolio managers. As a part of the approach we look for companies where:

- ESG drivers complement existing improvement opportunities
- High-return business models limit drawdown volatility
- Strong social and governance practices can help reduce idiosyncratic risks

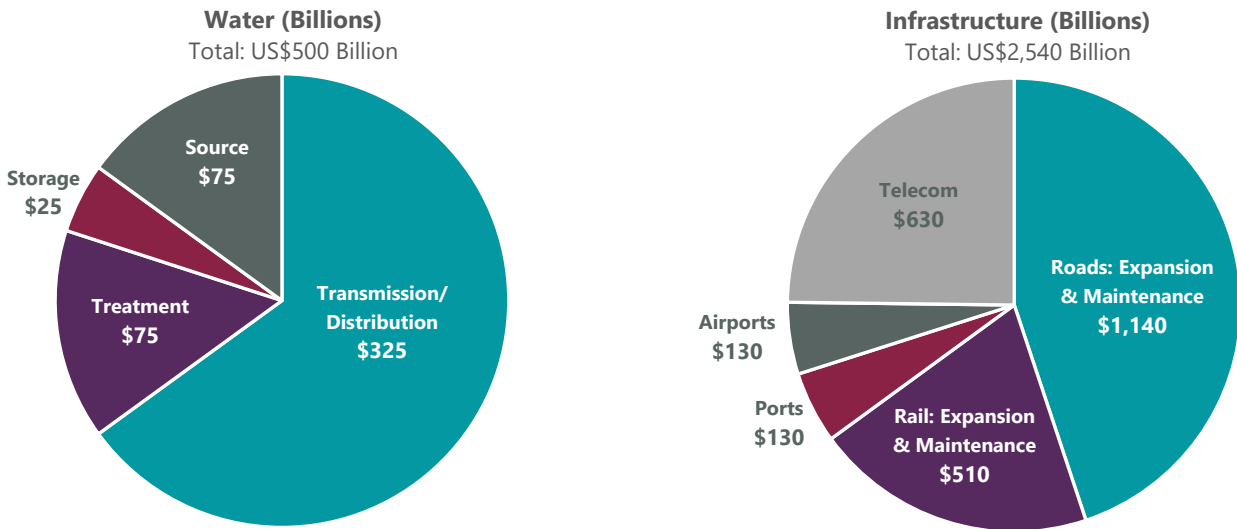
Key to our process is understanding how a company's ESG policies are evolving. We gauge this in several ways, such as by evaluating companies' capital expenditures directed at increasing future ESG business alignment, colloquially known as "green capex." There is a large mosaic of capex needed to support global sustainability initiatives such as net zero and more resilient water and infrastructure systems (Exhibits 4 & 5), with companies across the economy participating.

Exhibit 4: A Large Mosaic of Green Capex to Grow Future Business



As at 12 May 2023. Source: Goldman Sachs Investment Research. Net zero spending is estimated as the total investment amount needed annually over the next seven years in order to achieve net zero carbon emissions globally by 2050.

Exhibit 5: Water and Infrastructure Also Need Green Capex Investment



As at 12 May 2023. Source: Goldman Sachs Investment Research. Total infrastructure spending is estimated as the investment amount needed to be spent annually to reach infrastructure-related UN SDGs globally by 2035. Water spending is estimated as the investment amount needed to be spent annually up to 2030 to achieve water-related UN SDGs globally by 2035.

By assessing companies’ allocations to ESG initiatives relative to their overall capital expenditures, we can assess companies’ ESG priorities and expectations, as well as use them as a forward-looking measure to track progress. Ultimately, we believe companies committed to increasing their percentage of green capex will be better positioned to participate in long-term sustainability trends and deliver successful outcomes.

Engaging on KPIs in a Global Framework

Through our engagement with companies, we work to develop key performance indicators (KPIs) that give us insight about the amount and pace of a company’s efforts in achieving their ESG goals in areas such as emissions reduction, diversity and board effectiveness. We believe this approach allows us to make independent and insightful assessments about a company’s long-term initiatives, rather than judge them on historical poor performance. As a global portfolio, we also have the added flexibility of being able to search for potential holdings in both highly developed ESG markets, such as Europe and the U.S., as well as markets still developing a comprehensive ESG framework, such as Asia and Latin America.

Value Investing for a Margin of Safety

As long-tenured value investors, we begin the investment process by using screens and valuation metrics to surface companies trading at a discount to our assessment of their intrinsic value. We then seek to identify the ones where we believe current or emerging ESG initiatives and trends will be long-term value accretive. Our value approach helps identify opportunities with significant valuation discounts, which can provide a margin of safety.

Working with our robust central research platform comprising experienced sector analysts, we use several methods to identify attractive value opportunities, including:

- Scenario analysis
- Forward-looking and reverse-engineered discounted cash flow models
- Historical valuations

In addition to compelling catalysts, we seek out companies with understandable business models and good management teams that we feel are capable of effectively guiding their companies through sustainability transitions and improvements. We model out a wide range of outcomes before finally selecting companies with the most favorable risk/reward for inclusion in the portfolio.

A Three-Bucket System for Identifying Sustainability Improvers

ClearBridge classifies sustainability improvers into three separate categories: enabler, reformer and promoter.

Enabler

Enablers are typically companies whose products enable greater energy efficiency and lower natural resource use by other companies across different sectors. While growth and IT companies are often considered the vanguard of developing new technology to help meet ESG goals, overlooked is the fact that they rely on companies across a broader range of sectors to manufacture the tools and implement the processes that enable real long-term change. We believe enablers are the backbone in helping ESG laggards across the economy improve their ESG profile, and this compounding effect makes them especially critical to an investment approach focusing on ESG improvers. From a financial perspective, enablers often see new revenue opportunities from ESG-related sales, thereby accelerating their growth rates and driving stock multiple re-ratings.

Case Study: Siemens

Siemens is a German industrial automation and electrification leader working directly with customers who use its products and processes to help reduce power usage and improve resource consumption. Although it generated 0.6 million tons of Scope 1 and 2 CO₂ emissions in 2022, Siemens has helped its clients avoid 150 million tons of CO₂.⁵ Enablers like Siemens are playing a pivotal role in helping companies improve, while simultaneously increasing their own business opportunities through cross-selling to existing clients and raising its awareness to prospective ones. KPIs to help map progress toward their sustainability targets include:

- Achieving net-zero operations by reducing carbon emissions by 55% by 2025 and 90% by 2030.
- Reducing supply chain emissions by 20% by 2030 and achieving net-zero supply chain emissions by 2050.
- Increasing female representation in senior management to 30% by 2025 from 22.7% in 2020.

Reformer

Reformers are typically companies actively improving their sustainability profiles. Many operate in traditionally heavy emission or polluting industries currently undergoing a transition to become more environmentally sustainable. However, we also consider this category to encompass companies that have had societal and governance issues such as a lack of diversity, avoidance of underserved communities, labor issues and corporate structures that create conflicts of interest between management and shareholders. From a financial perspective, reformers typically trade at steep discounts to market multiples because of their ESG misalignment, and thus have the opportunity for significant share price appreciation if they can demonstrate improvement.

Case Study: TotalEnergies

TotalEnergies is a global integrated oil company headquartered in France. Despite a history of fossil fuel exploration and production, TotalEnergies is quickly becoming an industry leader due to its greater investment and integration of renewables and liquefied natural gas (LNG) into its energy production mix. KPIs to strive for over the next few years include:

- A 2030 production mix target of 40% of total energy commodities produced as oil and clean-burning natural gas, and 20% sourced from low-carbon molecules including renewables like solar, wind and hydropower.
- Increasing the company's proportion of its full-cycle capital expenditure budget (approximately US\$14-US\$18 billion) spent on low-carbon energy sources from 25% currently to 33% by 2030.
- Reducing the company's Scope 1 and 2 emissions by 17% by 2025 and 40% by 2030, and methane emissions by 50% and 80% over the same periods, compared to the levels found in its initial study in 2015.

Promoter

While much of ESG investing is focused on net zero, we prefer a broader framework centered around the 17 United Nations Sustainable Development Goals (UN SDGs) when looking for companies truly making an impact on sustainability. Examples include health care companies critical to improving health and well-being, financial companies that can expand financial inclusion and finance sustainability initiatives and food companies that are integral in promoting downstream (hunger and nutrition) as well as upstream (biodiversity)

improvements. Promoters, whose products or services have a direct impact on furthering the UN SDGs, pursue these types of opportunities. From a financial perspective, promoters represent idiosyncratic undervaluation opportunities across a broad array of sectors that enable portfolio diversification.

Case Study: AstraZeneca

AstraZeneca is a global pharmaceutical company with strong drug franchises and an innovative pipeline in oncology, cardiovascular/renal, respiratory, immunology and vaccine medicines devoted to substantially enhancing patient care and helping to reduce mortality. The company ranks third on the 2022 Access to Medicine Index, which evaluates companies based on their governance, R&D and product delivery, in helping improve health care access and affordability globally. Additionally, the company’s vaccine initiatives have received widespread recognition thanks to the over three billion vaccines AstraZeneca produced on a non-profit basis during the COVID-19 pandemic, of which two thirds were distributed to low and middle-income countries saving an estimated six million lives in the first year alone. Our KPIs for AstraZeneca are tied to how it promotes improving health outcomes, access to health care and progress towards UN SDG #3, which focuses on good health and well-being:

- Assessing the company’s continued success in developing new and innovative medicines by utilising the number of new product approvals and peak projected revenue from these drugs and treatments as an estimate of overall health care impact.
- Increasing the reach of the company’s Healthy Heart Africa program from 44.63 million people in 2022 to 50 million by 2025.
- Training 170,000 new health care workers by 2025.

Exhibit 6: ClearBridge Categories of Sustainability Improvers

Type of Improver	ESG Drivers	Valuation Drivers
Enabler	Companies critical in the field of advancing ESG objectives through enabling other firms, or the system as a whole, to improve on sustainability metrics.	New revenue opportunities from ESG-related areas --> re-rating from higher structural growth.
Reformer	Companies that had sustainability issues in the past that are now transforming to a more sustainable business mix or practice.	Reducing ESG misalignment, which is the reason for existing valuation discount --> re-rating away from extreme pessimism.
Promoter	Companies whose businesses are advancing sustainable objectives.	Advancing sustainability across broad array of industries --> unique valuation opportunities helping to achieve portfolio diversification.

Source: ClearBridge Investments.

Portfolio Risk Management: ESG Can Buffer Value Stocks’ Cyclicity

We believe the return drivers from ESG improvement among value stocks discussed here can provide a beneficial buffer against the more cyclical nature of these companies. Studies have shown that greater cyclicity and sensitivity to the economy can reduce a company’s value estimation.⁶ However, companies improving their ESG profiles can augment downside risk management as they take advantage of long-term trends like electrification and decarbonisation, offsetting short-term pressures from cyclical volatility and style rotations where value is out of favor.

We believe investing in sustainability improvers also helps overall portfolio construction. Best-in-class ESG strategies, heavily skewed toward sectors such as information technology, tend to have high correlations to growth factors and less diversification. However, the addition of sustainability improvers into an overall asset allocation helps provide greater exposure to value sectors and affords investors greater diversification while still advancing their ESG commitments.

⁶ D. Tremolizzo, “Mis-valuation of cyclical companies; An Empirical Research”, July 2009, Erasmus School of Economics, Erasmus University Rotterdam.

Conclusion

ESG investors have traditionally punished companies for bad behavior, failing to acknowledge recent efforts to improve and make progress on their ESG goals. ClearBridge recognises that making real progress on sustainability goals requires contributions from both ESG leaders and laggards. Contrary to public perception, ESG analysis and value investing are not mutually exclusive. Rather, their combination offers compelling opportunities as companies reduce costs, improve their access to capital, gain shareholder approval and better navigate changing regulations, offering the right investment approach ample opportunity to generate alpha from sustainability progress.

About the Authors



Grace Su

Managing Director, Portfolio Manager

- 22 years of investment industry experience
- Joined ClearBridge Investments in 2008
- MBA in Finance from the Wharton School at the University of Pennsylvania
- BS in Business Administration from the Haas School of Business, University of California, Berkeley



Jean Yu, CFA, PhD

Managing Director, Portfolio Manager

- 21 years of investment industry experience
- Joined ClearBridge Investments in 2002
- PhD in Molecular Biology from Columbia University
- MBA in Health Sector Management and Finance from Duke University
- MD from Beijing Medical University

ClearBridge Investments
ClearBridgeInvestments.com.au

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