White Paper
Fundamental Growth and Core Equity

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Investing in Sustainable Growth
Q3 Newsletter

STATE STREET GLOBAL ADVISORS

Contents

Volatility, Inflation and Tight Financial Conditions

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Global central banks, led by the US Federal Reserve, sustained an aggressive global tightening cycle to moderate increasing levels of inflation in the third quarter. Markets were mired by the macro-driven volatility as investors sold risk assets.

Equities declined for a third consecutive quarter across the globe as the long-term effects from war in Ukraine, COVID, and a strong US dollar kept inflation elevated. Rate-sensitive markets came under pressure as financial conditions intensified. Public markets continue to search for signals that inflation is peaking and are anticipating an end to the interest rate cycle by the US Federal Reserve. Market volatility will likely remain high as we wait for the answers and as global economies slow.

Earnings momentum has slowed and valuation multiples have significantly contracted across markets and sectors. Bottom-up opportunities exist within our universe as Quality and Growth has lagged globally for most of the year to date while Value has led. The current reporting season represents another test of earnings and guidance resiliency as the US dollar has remained strong and operating margins are under pressure.

The first article in our newsletter highlights some holdings that exemplify our Global Innovation Strategy's aim to generate long-term performance by finding quality market-leading businesses that can deliver innovative products and solutions. The second article describes how the Inflation Reduction Act's framework supports climate transition initiatives and decarbonization incentives.

Below the Radar: Three Innovation Stock Stories

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The Global Innovation Strategy seeks to build a concentrated portfolio of companies at the forefront of innovation, in a diversified, risk-controlled way. We favor companies with high-quality business models, reasonable valuations, and sustainable growth driven by innovative products and solutions.

More specifically, we define innovative companies as those that create new markets, disrupt existing markets, leverage the network or platform effect (as we illustrate later), and drive productivity enhancements, scientific breakthroughs and new solutions.

The Fundamental Growth and Core Equity (FGC) team's research process identifies companies with these attributes through its forward-looking, qualitative assessment of a company's Market Position. This is one aspect of our proprietary Confidence Quotient (CQ) process, which is driven by the judgment and expertise of our global analyst team.

CQ provides structure to how our team evaluates quality, bringing rigor, measurability and consistency to the process of assessing five elements of quality that we score and track over time. Each element of CQ is backed by a detailed scorecard that provides a framework for determining our confidence in the company's quality.

Confidence Quotient

- **Market Position** Sustainable competitive advantage
- **Management** Conviction in leadership
- **Financial Condition** Strength of the financial model
- **Transparency** Visibility of business
- **Fundamental Momentum** Business is trending positively

Source: State Street Global Advisors Fundamental Growth & Core Equity. For illustrative purposes only.

In this article, we profile three such firms: IQVIA (US), Schneider Electric (Europe) and Mercado Libre (Latin America).

IQVIA

Market Position CQ Score: 7.5/10

Long-Term Growth Rate: 14%

- A differentiated, data-driven approach to clinical trials; unmatched breadth and depth of data; quicker recruitment, and site selection.

IQVIA is the product of a merger between Quintiles, a contract research organization (CRO), and IMS Health, a healthcare data vendor. Management at Quintiles believed leveraging data and technology could be disruptive in the CRO space, where firms' processes are typically manual, labor intensive, and inefficient. IMS Health had one of the largest healthcare datasets in the world but believed they weren't unlocking its full potential. The combined entity uses a differentiated, data-driven approach to clinical trials. More efficient site selection, patient enrollment, and start-up, has led to faster trials and market share gains.

Competitors of course have plenty of data too, but the breadth and depth of IQVIA's data is unmatched. IQVIA combines data from traditionally insulated platforms like pharmacies, labs, and providers on a global scale: over 100 billion healthcare records; 85% of global prescriptions; over 1 million data feeds; over 2 trillion annual data transactions; and over 45 petabytes of unique data.[1] Moreover, IQVIA has the ability to analyze and act on the data quickly and efficiently by organizing the data into a searchable database.

So how has this tech-enabled approach fared in practice? Historically, 80% of trials are delayed, often due to recruitment challenges, and 60% have a protocol amendment, leading to longer trials and higher costs.[1] Site selection is the most critical part of the clinical trial; IQVIA's digitalized approach has led to a 33% reduction in site identification times and 34% faster recruitment.[2] This, unsurprisingly, has resonated with customers such as biopharma clients, leading to market share gains.

Management's forward-thinking approach and differentiated data assets has resulted in high Management and Market Position scores on our CQ framework. While the firm's leverage is moderately high (net debt/EBITDA of 3.9x,on a trailing twelve months basis), the CRO industry's sales backlog and legacy subscription data provide clear revenue visibility ($25.6 billion backlog, of which $7.0bn will convert to revenue in the next 12 months). In 2021, the global pharmaceutical industry spent over $210bn on research and development,[3] with approximately half of this addressable by the CRO industry.[1] There are over 30,000 drugs in the development[3] pipeline, 60% of which are biologics.[4] Much of the growth is being driven by small biotechnology companies that lack the manpower and infrastructure to perform research and conduct trials in-house. This will lead to continued CRO outsourced penetration (~50% currently), driving a 6% industry CAGR[1] (compound average growth rate), with IQVIA growing at an above-market pace due to its differentiated approach.

Schneider Electric

Market Position CQ Score: 7.6/10

Long-Term Growth Rate: 11%

- The score reflects Schneider's strong integrated hardware and software solutions to building management, electrification and digitization, which leads to robust pricing power and a solid competitive moat.

Schneider Electric is a leading global electrical equipment manufacturer with over €31 billion in revenues, headquartered in France with operations in over 100 countries worldwide. Schneider operates in two segments, Energy Management and Industrial Automation. The share of existing buildings that would need to be retrofitted for electrification and energy efficiency to reach this goal would grow from less than 1% in 2020 to around 85% in 2050.[5]

We believe Schneider Electric is an innovator because the company quickly recognized electrification in decarbonization as a secular growth opportunity. Electricity will play a key role in reducing global emissions because it can be supplied from non-carbon sources and generates no emissions. Schneider has refocused their business model to become a provider of sustainability and energy efficiency solutions.

Over the last decade, Schneider has made substantial software investments, both internal and through acquisition. The company rolled its portfolio of electrical products into its Internet of Things architecture (EcoStruxure) and industrial design and construction software, providing comprehensive electrification and digitization solutions for their customers as they progress toward decarbonization targets. About 80% of company revenues are now related to electrification, and Schneider has the largest absolute revenue exposure to electrification of any global industrial player.

As a leading global player in sustainability and decarbonization solutions, Schneider scores very well in the FGC team's CQ framework (outlined on page 4). Their strategic focus on electrification and digitization has driven organic revenue growth above peers, along with steady margin improvement ahead of the company's stated targets. Their combined hardware and software solutions have driven recurring revenue growth through long-term service contracts.[6] Schneider has also set best-in-class internal sustainability targets, including carbon neutrality by 2025 for internal operations and Net Zero ready operations by 2030.[7] The company's strong track record is reflected in the Management Team and Market Position CQ scores, and their strong and effective messaging on ESG concerns to the investment community is reflected in the ESG components of those scores.

The market opportunity for electrification going forward is substantial. Morgan Stanley estimates the current US Electrical TAM (Total Addressable Market) at $48 billion and estimates that it could grow to $150bn by 2040.[8] In the European Union (EU), the electrification of all commercial and residential buildings to achieve Net Zero 2050 would nearly double overall electricity demand in the region. The share of existing buildings that would need to be retrofitted for electrification and energy efficiency to reach this goal would grow from less than 1% in 2020 to around 85% in 2050.[9]

At their November 2021 Capital Markets Day, Schneider set a target of 5–8% core revenue growth through 2024, ahead of their industry-leading 4.1% CAGR from 2017–21. Their longer-term sustainable core growth target through economic cycles is now 5%.[10] Assuming the electrification market develops according to the forecasted requirements to reach Net Zero targets, Schneider will likely be in a very attractive long-term competitive position, and should be very well placed to meet or exceed their growth targets.

Mercado Libre

Market Position CQ Score: 8.1/10

Long-Term Growth Rate: 15%

- The score reflects its leadership in e-commerce in Latin America, driven by a two-sided platform in e-commerce and fintech services, more diversify product assortment and strong logistics network. Its superior services level has been attracting brand names to its e-commerce platform.

Mercado Libre (MELI) is the leading e-commerce player and payment network in Latin America (LatAm), offering the most integrated ecosystem in e-commerce and digital payments services. MELI has approximately 12 million sellers on its platform, 372 million live product listings and 84 million active users in Q2 2022.[11] These are notable elements of the network/platform effect that we are seeking in innovative business models. Sellers have to go where the buyers are and vice versa, and having a first mover advantage or simply a better platform can be key.

LatAm has one of the fastest growing e-commerce penetration rates in the world, and MELI has consistently grown faster than other players in the region due to its superior e-commerce ecosystem. In 2021, the firm achieved a gross merchandise value (GMV) of US$28 bn, a three-year growth rate of 32% per annum, and shipped almost 1 billion items in 2021 — a three-year growth rate of 63% per annum.[12] Therefore, we believe MELI's Market Position CQ score will continue to improve as it outpaces competition in scale as it increases its market share in LatAm, boosting our confidence in MELI to deliver long-term sustainable growth.

E-commerce and Fintech Driving Sustainable Growth

MELI's two-sided platform in e-commerce and fintech has been key in driving sustainable growth at the company. The company has continued to drive innovation and implement new initiatives to improve the company's position:

1. **Logistics** MELI developed its own logistics network in the last five years, reaching almost 90% of deliveries in its own managed network.[13] Controlling logistics is crucial for success, ensuring a fast delivery time while controlling shipping costs and improving the level of customer service. MELI is in the early stages of charging for this service, providing it with a new revenue opportunity.

2. **Product Assortment** This drives customer loyalty, increasing traffic and the number of purchases. MELI is the market leader on this metric as it has become the "everything store" in LatAm. The GMV is well diversified with no vertical accounting for more than 15–20% of the total. This provides support compared to some competitors with verticals that are more sensitive to high interest rates which are experiencing a significant slowdown.

3. **Fintech** MELI originally offered payments services to facilitate e-commerce transactions for merchants and users. Over the last five years, the number of product offerings has gradually increased and MELI currently has 38 million fintech users, 21.4 million wallet users and 22.4 million investment accounts.[14]

4. **Advertising Services** Although in the early stages, advertising services are becoming increasingly relevant. MELI is focused on deploying better tools for merchants to access, manage, and optimize their advertising spend on its platform. There are still more technological developments emerging to unlock sustainable growth.

5. **From Taobao (C2C) to Tmall (B2C)** Over the years, improving service levels attracted brand names (official stores) to MELI's e-commerce platform. Official stores, which include Apple, Samsung, Adidas, and Disney, account for over 25% of GVM.[15] In the past, MELI's transactions were mainly C2C, while B2C transactions were dominated by small size merchants.

MELI is ahead of its competitors in all of the initiatives mentioned above. These initiatives continue to evolve and we believe there is more scope for the company to monetize traffic, increasing take rates (i.e. transaction fees). We see revenue growth opportunities in advertising, fulfillment services, and new value-added products in Fintech such as insurance, investments, and wealth management solutions.

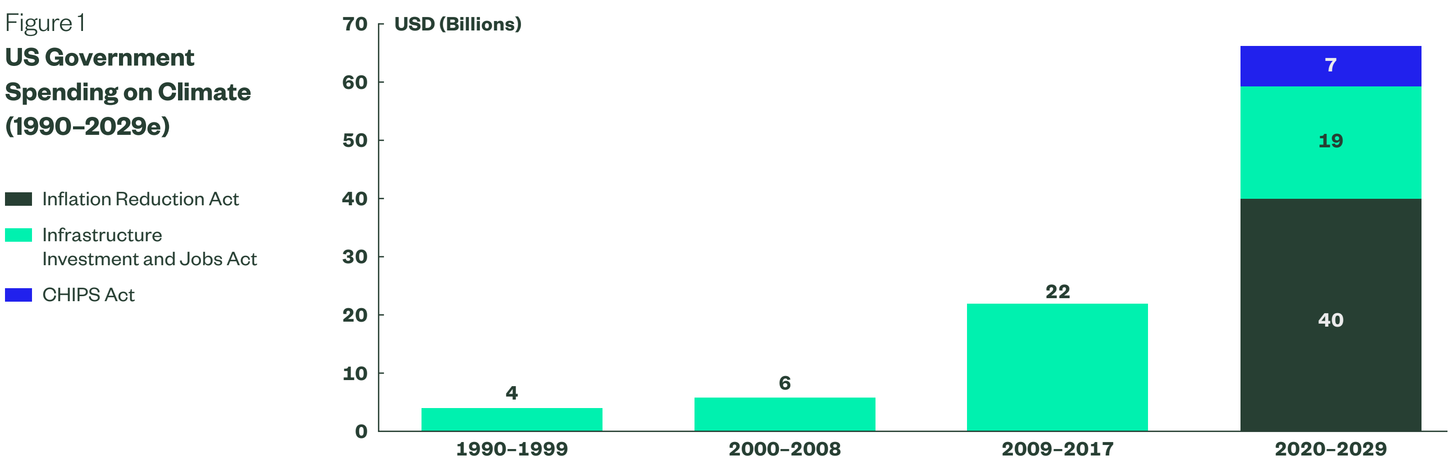
Inflation Reduction Act: Pathway to a Lower Carbon US Economy

Shaman Srivastava
Research Analyst

The Inflation Reduction Act 2022 includes a number of substantial measures to help the US in its transition to a lower carbon economy. It is set to have a considerable impact on the climate change strategies of many industries and companies.

On August 12, 2022, US President Joe Biden signed into law the Inflation Reduction Act (IRA). This Act is considered to be the strongest climate action in US history and aims to address inflation by reducing national debt, healthcare costs, and energy costs over the next ten years. On the climate change front, the law encompasses provisions that touch on a mix of energies, including wind, solar, nuclear, hydrogen, oil and gas, biofuels; it also includes climate change prevention measures such as carbon capture, battery storage, clean vehicles etc. Overall, an estimated $369 billion of investment is expected in the areas of energy transition and climate change over a period of 10 years.

Figure 1
US Government Spending on Climate (1990–2029e)



Source: RMI, Credit Suisse Estimates as of 21 August 2022.

Major Beneficiaries of the IRA

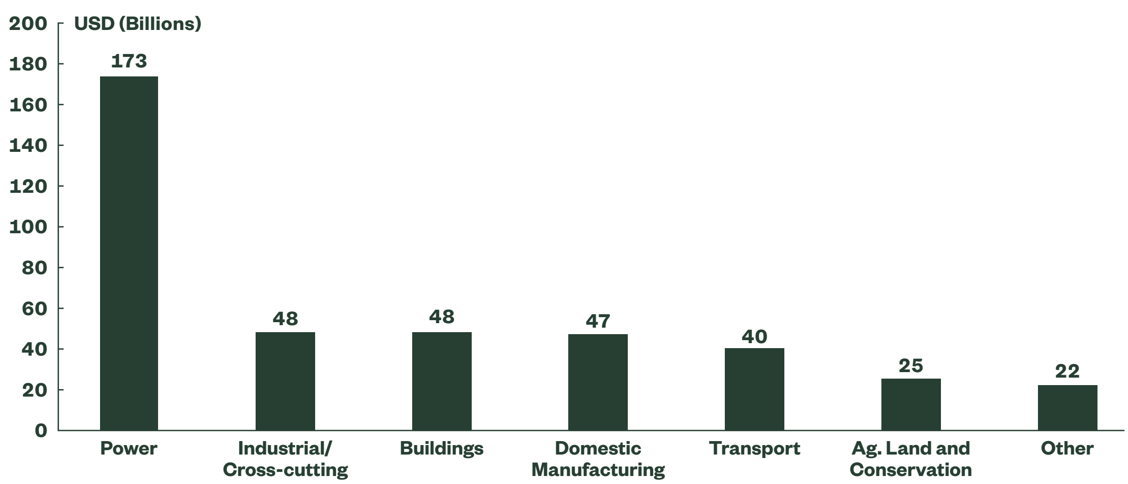
Some of the key industries/technologies that will benefit from the Inflation Reduction Act are:

1 **Renewable Energy** The IRA will make renewable energy, such as wind and solar, even more competitive in the US by means of a Production Tax Credit (PTC)[16] extension and expansion, and the Investment Tax Credit (ITC) extension. The IRA extends the PTC, which is currently being phased out under existing policy, and it returns the credit to a full $30/MWh for qualifying renewable sources like wind, biomass, geothermal and certain hydropower projects. The Act brings the ITC, which is also being phased out, back to a full 30% credit for technologies including solar power, fuel cell properties and waste-to-energy facilities. The ITC will also be available for new standalone energy storage systems over 5 kWh and those co-located with solar power projects.

2 **Low-carbon Hydrogen** The newly-introduced Clean Hydrogen Production Tax Credit is a 10-year credit of up to $3 per kilogram (kg) of clean hydrogen, starting from the date the qualifying production facility begins its operations. The full PTC will be available for hydrogen that has a lifetime emissions rate of less than 0.045kg of CO_2 equivalent per kg. Hydrogen produced with emissions greater than 0.045kg through 4kg will be eligible for partial credits. Clean hydrogen producers can also elect direct payment instead of tax credits.

3 **Carbon Capture Utilization & Storage (CCUS)**: The IRA provides critical updates to the 45Q tax credit, which incentives the use of carbon capture and storage. This is a climate solution that the Intergovernmental Panel on Climate Change (IPCC) and the International Energy Agency (IEA) have determined as likely to play a vital role in efforts to address climate change. The tax credits have been increased up to $85/ton for storage and up to $180/ton[17] for direct air capture. By enhancing and expanding the 45Q tax credit, the US government has made it significantly more accessible to a broad array of investors and developers. This will make carbon capture a critical tool for hard-to-abate sectors such as cement, steel, refineries and power generation to decarbonize their operations.

Figure 2
IRA Climate-Related Funding Allocation



Source: Congressional Budget Office, Credit Suisse estimates as of 21 August 2022.

Oil & Gas Sector: Decarbonization Opportunities Presented by IRA

The Oil & Gas sector is the main enabler of CCUS technology to achieve climate objectives. CCUS can remove very large amounts of carbon as work is progressed to replace hydrocarbons from our energy mix. This technology does not get as much attention as renewables, but this process can remove significant levels of CO_2 from large emitting industrial complexes. The technology is well understood but cost has been a obstructive factor until now.

The Inflation Reduction Act provides incentives to scale up CCUS projects and has the potential to increase by a multiple of 5 up to 100 million tons[18] of carbon capture by the end of the decade. US oil and gas companies are by far the most advanced in CCUS and have been engaged in carbon capture for many years, something that has been largely unnoticed by the market. Companies like ConocoPhilips, Chevron, Exxon Mobil and Schlumberger have major initiatives underway; the new legislation raises tax credit from $65t/$CO_2$ to $85t/$CO_2$, so we can expect more large-scale CCUS projects to be developed.

The Oil & Gas industry has a major role to play in our journey to Net Zero. The industry has been criticized in the past around their climate ambitions, but they have recently significantly stepped up their plans to decarbonize their operations. With their strong knowledge of hydrogen and CCUS, they are instrumental in the transition to a low-carbon economy.

The table below highlights the initiatives of some US-based oil and gas companies:

Figure 3
US-based Oil and Gas Companies

ConocoPhillips	Schlumberger	Chevron	ExxonMobil
In 2021, evaluated potential CO_2 storage sites along Texas and Louisiana Gulf Coast for supply to industrial emitters	Presence in carbon capture business for more than two decades	Decades of operational excellence in carbon capture projects; 2030 target of 25 million tons carbon capture per year	Leader in carbon capture with current capacity around 9 MTPA; cumulatively captured 120 Mmt, approximately 40% of all anthropogenic CO_2 that has ever been captured
2050 Net Zero roadmap includes Scope 1 and Scope 2 emissions reduction projects, portfolio high-grading, investment in carbon capture and storage	Recently explored creating strategic partnerships to assess, develop, and operate projects spanning the entire CCS value chain, from capture to storage	Gorgon facility — one of the largest in the world — has a capacity to store up to 4 million tons per year	LaBarge facility can capture 6–7 MTPA of CO_2; plans to expand capacity by an additional 1 million metric tons by 2025

Source: State Street Global Advisors. Company accounts, as of 30 September 2022.

IRA: The Impact on Emissions

The IRA injects major funding into US efforts to become a Net Zero economy by 2050. A key aim of the Act is to put the US on an accelerated path to achieve the country's 2030 goal of reducing greenhouse gas (GHG) emissions by 40% below 2005 levels.[19]

The IRA could cut annual emissions in 2030 by an additional 1 billion metric tons below the emissions projected in the current policy. According to a report from Princeton University,[20] the emissions reduction is primarily driven by the accelerated deployment of clean electricity and electric vehicles, reducing the 2030 emissions by ~360 Mt and ~280 Mt, respectively. The Act also incentivizes the installation of efficiency upgrades and carbon capture in the industrial sector, contributing about 130 Mt of reductions. As per estimates in a study by Princeton University researchers, the IRA closes about two-thirds of the remaining emissions gap between current policy and the nation's 2030 climate target (of 50% below 2005 levels).[21]

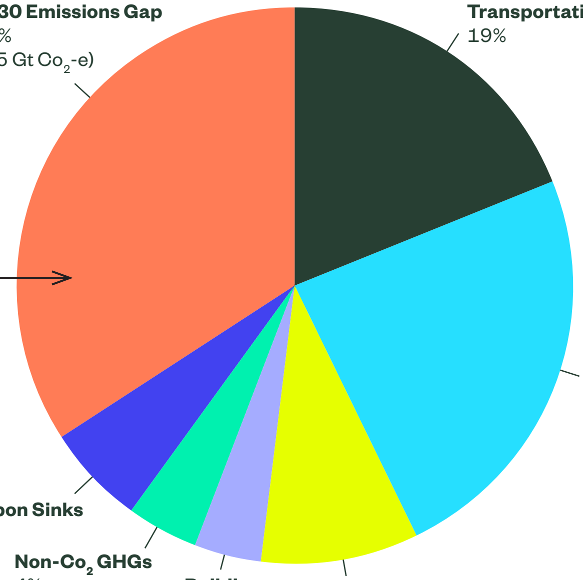
By driving down the cost of clean energy and other climate solutions, the Act makes it easier for states, cities, or companies to increase their climate ambitions. It also reinforces the economic benefits of any future federal regulations.

Figure 4
Contributions From the IRA to US Greenhouse Gas Emissions Reduction Needed to Reach 2030 Climate Target

The *Inflation Reduction* Act **closes about two-thirds of the remaining emissions gap** between current policy and the nation's 2030 climate target (50% below 2005).

By driving down the cost of clean energy and other climate solutions, the Act also **makes it easier for states or cities or companies to increase their climate ambitions.**

It also reinforces the economic benefits of any future federal regulations. (these dynamic effects of the bill are not captured in this modeling.)



Source: The Climate and Energy Impacts of the Inflation Reduction Act of 2022, Princeton University, Zero-carbon Energy Systems Research and Optimization Laboratory (ZERO Lab), August 2022.

Investment Opportunity Presented by IRA

The IRA offers an array of incentives and tax credits to the industries which will not only help in decarbonization but will also present a great investment opportunity. The Fundamental Growth and Core (FGC) Equity team at State Street Global Advisors believes that the IRA will provide incentives for the development and maturation of technologies which are critical in mitigating climate change. By leveraging the FGC proprietary climate score cards we can identify companies that will provide the key technologies to enable the transition to a Net Zero world. The FGC team also believes that companies will need to have ambitious and credible climate transition plans to adapt their business models to a zero-carbon economy. We strongly believe that the combination of robust climate adaptation plans and key enabling climate technologies will drive superior investment returns for shareholders.

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Glossary

Carbon Capture, Utilization and Storage CCUS is a process that captures carbon dioxide emissions from sources like coal-fired power plants and either reuses or stores it so it does not enter the atmosphere.

EBITDA A measure of net income with interest, taxes, depreciation, and amortization added back to it. It can be used to analyze and compare profitability between companies and industries because it eliminates the effects of financing and accounting decisions.

Greenhouse Gas Emissions Greenhouse gases are gases that trap heat in the atmosphere, the main ones being carbon dioxide, methane, nitrous oxide, and fluorinated gases.

Investment Tax Credit The investment tax credit (ITC) is a federal income tax credit for certain types of renewable and clean energy projects including solar, geothermal and fuel cell energy.

Net Zero 'Net Zero' means that the total greenhouse gas (GHG) emissions being emitted should be lower than or equal to the total GHG emissions being removed or absorbed. On a net basis, no additional emissions should be released into the Earth's atmosphere.

Production Tax Credit The Production Tax Credit (PTC) is a federal incentive that provides financial support for the development of renewable energy facilities.

Endnotes

1 IQVIA Company Accounts.

2 IQVIA Company Accounts.

3 Source: Jefferies.

4 Source: Danaher.

5 Paris Agreement, Article 2, Section 1 (a).

6 Schneider Electric Capital Markets Day 2021 Financial Framework for Sustainable & Scalable Growth.

7 Schneider Electric 2022 Net-Zero Commitment.

8 Morgan Stanley, Lightning in a Bottle: Electrification's Long Term Growth Potential July 1, 2021.

9 United Nations Net Zero Coalition statement on Climate Action, https://un.org/en/climatechange/net-zero-coalition.

10 Schneider Electric Capital Markets Day 2021 Financial Framework for Sustainable & Scalable Growth.

11 Source: MELI company accounts, as of 30 June 2022.

12 MELI Company Accounts.

13 MELI company accounts, as of 30 June 2022

14 MELI Company Accounts.

15 MELI Company Accounts.

16 The Inflation Reduction Act of 2022, H.R. 5376, 177th Cong. (2022). https://democrats.senate.gov/imo/media/doc/inflation_reduction_act_of_2022.pdf.

17 The Inflation Reduction Act of 2022, H.R. 5376, 177th Cong. (2022). https://democrats.senate.gov/imo/media/doc/inflation_reduction_act_of_2022.pdf.

18 BNEF.

19 Insider Staff. (2022, July 27). Summary: The Inflation Reduction Act of 2022. Insider Inc., Document Cloud. https://documentcloud.org/documents/22122297-inflation_reduction_act_one_page_summary.

20 The Climate and Energy Impacts of the Inflation Reduction Act of 2022, Princeton University, Zero-carbon Energy Systems Research and Optimization Laboratory (ZERO Lab).

21 The Climate and Energy Impacts of the Inflation Reduction Act of 2022, Princeton University, Zero-carbon Energy Systems Research and Optimization Laboratory (ZERO Lab).

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- Build from breadth
- Invest as stewards
- Invent the future

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* Pensions & Investments Research Center, as of December 31, 2021.
† This figure is presented as of September 30, 2022 and includes approximately $55.12 billion USD of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated. Please note all AUM is unaudited.

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