White Paper
Fundamental Growth and Core Equity

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Investing in Sustainable Growth

Q1 Newsletter

STATE STREET GLOBAL ADVISORS

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Looking Past the Veil of Uncertainty

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The Russia-Ukraine War has greatly increased geopolitical uncertainty at a time when financial markets, and in particular equity markets, are trying to come to terms with shifting growth and inflation expectations. Expectations for global GDP and corporate earnings have fallen amidst an acceleration in monetary tightening; the Federal Reserve is signalling it could bring forward rate increases and other measures to combat inflation.

The war in Ukraine is exacerbating an already worrying global inflation situation via sharply higher energy, commodity and agricultural prices. With logistics and supply chains still disrupted by the lingering effects of the pandemic, the rise in energy prices, especially in petrol, is pressuring governments to take action on the fiscal policy front. The sizeable deficits and debt accumulation during the pandemic period means that significant fiscal easing is difficult for some governments to implement.

This combination of factors is resulting in lower expectations for economic and earnings growth combined with higher price levels and higher interest rates. Stagflation concerns may accelerate as the economy slows amid higher interest rates and as unemployment levels begin to increase.

Despite the environment, we remain constructive on equities over the medium term. Our base case is that inflation rates will decelerate as some of the logistics-induced supply chain constraints are resolved and as the economy slows. In addition, we expect wage growth to moderate and, most importantly, that longer-term productivity investments will begin to provide support.

We remain focused on long-term opportunities that offer Quality, Sustainable Growth, and Reasonable Valuation. Our quality framework places a premium on market position, driven by competitive position and pricing power — both of which we believe to be necessary to navigate the current environment.

We believe climate transition strategies will be a key growth driver as companies execute their decarbonization plans to reduce global greenhouse gas emissions. Our first article explores carbon pricing models and the impact they can have on capital allocation. In a similar vein, our second article takes a deep dive into Saint Gobain, a building materials supplier well-positioned to benefit from Europe's plan to reduce net carbon emissions.

Carbon Pricing Markets: A Micro View

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Much has been written about the urgency to reduce carbon emissions. Corporates have a major role in fighting climate change and forming a deep understanding of their climate transition strategies will help investors assess the potential impact on their businesses and financial performance. Limiting global warming to well below 2 degrees Celsius requires substantial decarbonization strategies. These can come from regulations to limit emissions and, importantly, from changes in corporate behavior such as factoring carbon pricing into capital allocation decisions.

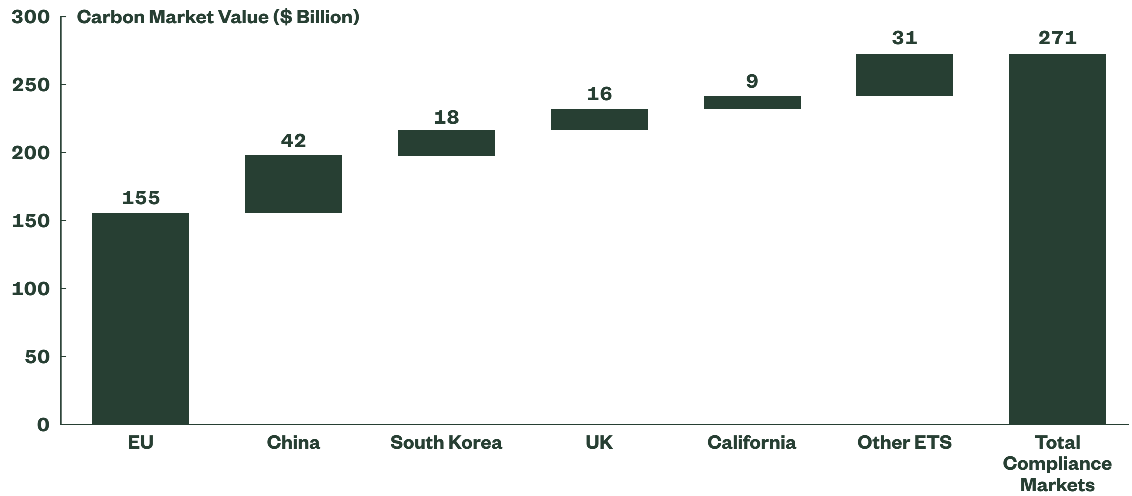
The two strategies are inter-linked and it is important for investors to understand how carbon pricing can impact the financial performance of companies they invest in, and also the business opportunities that will come from the creation of carbon markets.

The Emergence of Carbon Markets

With the increased focus on moving towards a net zero world, where the production of greenhouse gas (GHG) emissions and the amount removed from the atmosphere are in balance, there will be a significant expansion of global carbon markets. An overview of the world's 2000 largest publicly-traded companies by revenue suggests that around half of those companies have committed to a net zero (or carbon neutral) target by 2050, along with countries responsible for around 88% of global GHG emissions.[1] These rapidly increasing commitments are leading to a greater number of corporate and national action plans to transition to net zero, while also driving activity in the carbon markets, of which two forms dominate:

1 **Compliance Carbon Markets** This form of carbon market allows public and private corporations to obtain and surrender emissions permits (allowances) in order to meet the regulatory targets. These markets aim to establish a carbon price by regulations which control the supply of permits that are then distributed by national, regional and global authorities. These permits are then traded within a controlled emissions trading scheme (ETS), which gives an economic incentive to the participating organizations to reduce their carbon footprint. More than 60 carbon markets and taxes have been implemented around the world, covering 11.6 gigatons of CO_2 equivalent (GtCO2e) or 22% of the global greenhouse gas emissions — the Compliance Carbon Markets (CCM) account for around 75% of these emissions. The total market value of these CCMs is estimated to be over $270 billion. Significant new investments will be required in order to have efficient carbon markets and we would expect the financial services industry to be the main beneficiary.

Figure 1
The Growth in Compliance Carbon Markets

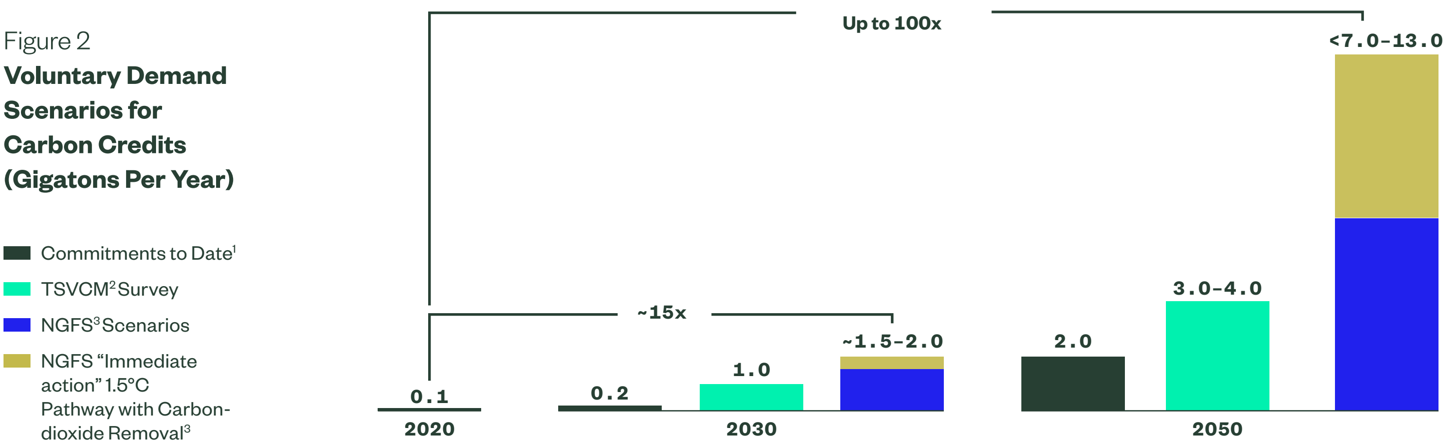


Source: BNEF, ICAP, CARB, Shanghai Environment and Energy Exchange, Korea Exchange, Credit Suisse Research.

2 **Voluntary Carbon Markets (VCM)** The voluntary form of carbon markets, though not legally mandated, is comprised of companies and organizations choosing to offset their emissions. The participants can buy carbon credits that channel funds into projects that either reduce or remove carbon emissions from the atmosphere, thus compensating for or neutralizing their own emissions. The voluntary carbon market was formed with the aim of driving finance towards activities that reduce greenhouse gas emissions. These carbon markets are enablers for companies to achieve their ambitious climate goals by complementing the internal emissions reduction — a necessary first step — with the purchase of offsets. Corporates that can decarbonize their business activities will be able to sell their credits, thus securing new revenue streams. The renewable energy sector has been a major beneficiary of VCM, while the auto industry has been a significant buyer of carbon credits to offset their downstream emissions.

Although the voluntary carbon markets have grown substantially over the past few years, they are still very small in size compared to the compliance markets. Some of the limitations to the development of these markets are the lack of standardization and the low credibility around the quality of carbon credits generated. The Taskforce on Scaling Voluntary Carbon Markets (TSVCM)[2] aims to address these limitations of the voluntary carbon markets by bringing in greater certainty, scale and liquidity. The finalization of Article 6[3] of the Paris Agreement is expected to bring substantial changes to the operations of voluntary carbon markets which would bolster demand from the private sector and give an impetus to investments on the supply side. As per an estimate by McKinsey, the annual global demand for carbon credits could reach 1.5 to 2.0 gigatons of carbon dioxide ($GtCO_2$) by 2030 and up to 7 to 13 $GtCO_2$ by 2050.

Figure 2
Voluntary Demand Scenarios for Carbon Credits (Gigatons Per Year)



Source: Network for Greening the Financial System (NGFS). These amounts reflect demands based on carbon dioxide removal and sequestration requirements under the NGFS's 1.5o and 2o scenarios.

Carbon Pricing: Potential to Change How Companies Set Business Strategy

Carbon pricing is a cost-effective policy tool that governments and companies can use as part of their broader climate strategy, creating a financial incentive to mitigate emissions through price signals. By accounting for climate change costs in decision-making, carbon pricing can help encourage adjustments in production and consumption patterns, thereby reinforcing low-carbon growth. Explicit carbon pricing instruments — carbon taxes and emissions trading systems — operate within a broad incentive structure that includes other policies, from which a carbon price can be derived. There are also internal carbon prices used voluntarily by corporations, organizations, and governments to guide investment decisions and promote efficiencies in business operations. Overall, most companies use internal carbon pricing to achieve one or more of three key objectives:[4]

1. For most companies, the key objective of carbon pricing is to drive low-carbon investments. The companies can do this by implementing an internal carbon fee where different business units pay a carbon price for their emissions. The revenue stream generated can be used for investments in low-carbon technologies. Microsoft, for instance, applies an internal carbon fee on its emissions (scope 1, 2, and 3 travel emissions). The revenue raised is invested in sustainability and carbon removal activities. French automobile manufacturer Renault uses its internal carbon pricing to promote energy efficiency in its manufacturing locations.

2 Companies that operate globally are unavoidably exposed to carbon-pricing standards, given the varied regulations on carbon emissions across jurisdictions. For such companies, it is advantageous to track, calculate and price their emissions to ease out operations across international pricing policies and standards.

3 Companies may also adopt a shadow price[5] mechanism to sensitize and change internal behavior and to assist in better understanding the potential impact of external carbon pricing on the profitability of a project, new business model or an investment. By doing this, the companies are able to manage the external risks of an increase in the price of emissions (in regions where the regulations already exist) or future-proof against any new regulations for pricing carbon emissions.

Corporations are just beginning to factor carbon pricing into their capital allocation decisions. As regulations expand and carbon markets develop, this will create inherent risks for investors but will also bring tremendous opportunities. Companies with the most robust climate transition plans will adapt their business models relatively unscathed while others might topple. The active Fundamental Growth & Core (FGC) equity team not only factors risks and opportunities into our proprietary Confidence Quotient research process through specific score cards to assess companies' climate transition plans, but also factors in the financial risks and opportunities from climate change on their business models.

Conclusion: Path to Net Zero to Bring Investment Opportunity

As the world decarbonizes, corporations are going to adapt how they direct investments to factor in carbon price; and the companies that will enable carbon markets are potentially going to reap considerable benefits. Climate change is often viewed mostly as a risk that investors must add in the construction of their portfolios. The FGC team believes that this risk is best mitigated by selecting companies with the most robust and credible climate transition plans. We also believe that the path to net zero will require huge investment in new technologies that will bring tremendous investment opportunities.

Saint Gobain: Riding the Renovation Wave

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The building construction industry is undergoing a significant adjustment in Europe. Updating the aging building stock in the region has been identified as an important part of the European Union's plan to cut net carbon emissions by 2030. As a leading supplier of building materials and solutions, Saint Gobain appears well placed to benefit from the renovation wave sweeping across Europe.

The Company

Saint Gobain (SGO) is a leading manufacturer and distributor of building materials used in residential and commercial construction in over 70 countries and has more than 167,000 employees. Saint Gobain deals with wide range of building products includes flat glass, insulation systems, interior systems, flooring and roofing solutions, ceramics, renovation solutions etc. which can decarbonize two-thirds of building-related emissions — 72% of its sales offer sustainable solutions. The company's business exposure breaks down as follows: 35% in new construction, 52% in the renovations market, and 13% in industrial high-performing solutions.

Transformed Organization

In the aftermath of the global financial crisis (GFC), SGO struggled to perform. Its earnings per share (EPS) grew by a modest 2% per annum during 2010–2018, on a compound annual growth rate (CAGR) basis. Some of this relatively poor performance was driven by a drop in real residential construction growth in Europe to 1% in 2008–2018 compared to 2% growth in the 1991 –2007 period. SGO sought to develop external growth in its distribution business where margins have contracted, while it was less active in areas where profitability has expanded since the GFC. The declining margins in the distribution business and weak capital efficiency put pressure on return on equity (ROE), which had declined to an average of 7% during 2009–2017.

SGO launched its 'Transform & Grow' (T&G) strategy in November 2018 to address the aforementioned challenges and successfully completed it well ahead of its original timeframe in June 2021 and with a better outcome than planned. The company improved its margin from 7.7% in FY2018 to 9.5% in H1 2021; 60 basis points (bps) of that came from divesting low profitable business sales worth €4.6bn (i.e. 11% of FY2019 sales), 60bps came from cost restructuring, and 60bps from volume and mix improvement via acquisitions and existing businesses. Recurring ROE improved to over 12% during the same period. To further strengthen the organization and capture growth opportunities, SGO launched its 'Grow & Impact' (G&I) strategy in October 2021, targeting 3–5% organic sales growth, a low double-digit operating margin, and 12–15% ROE.

Figure 3
Saint Gobain Turns Around Financial Performance

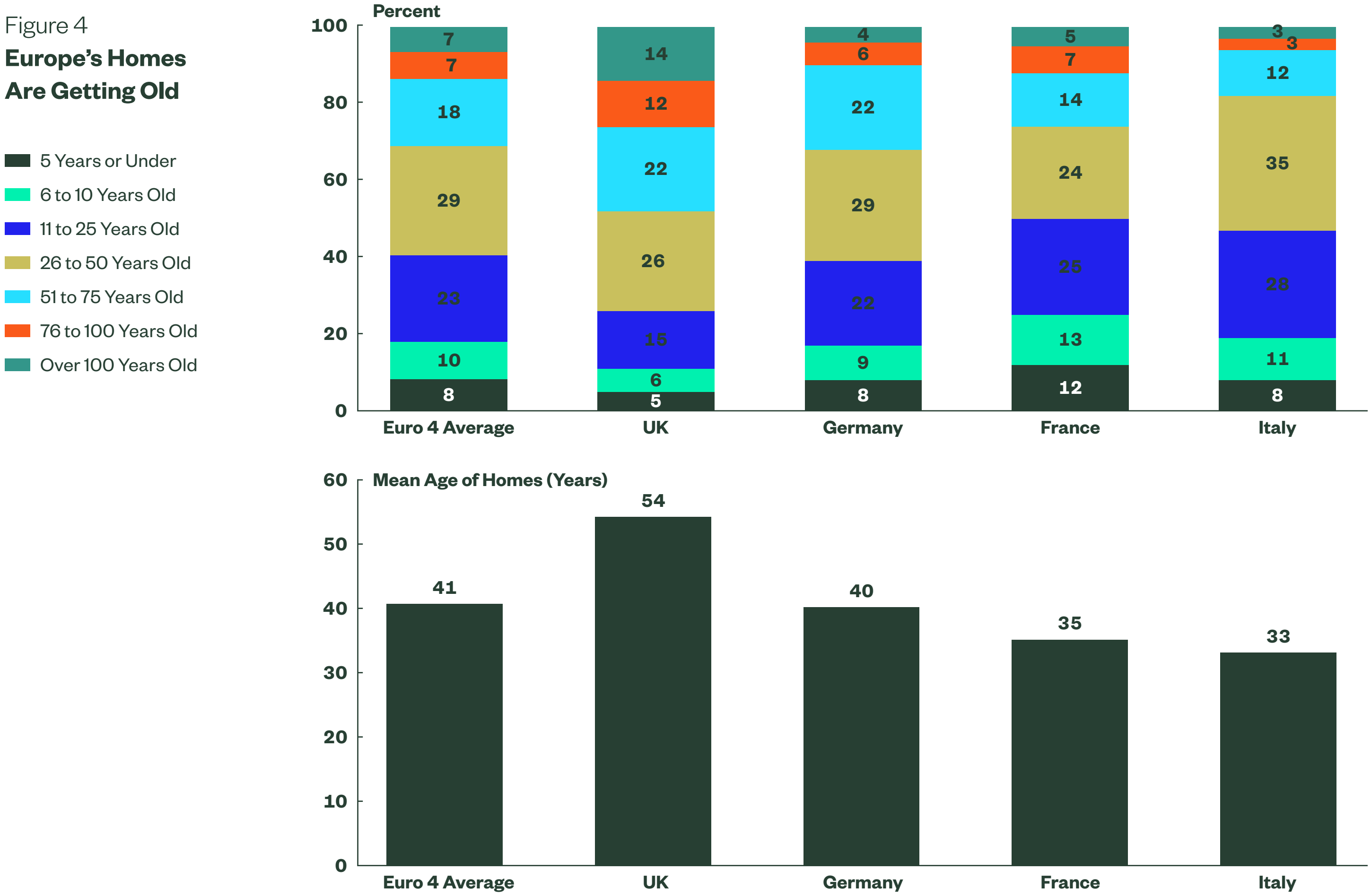
Source: Bloomberg Finance L.P., as of 31 December 2021. Past performance is not a reliable indicator of future performance. The above forecast is an estimate and there is no guarantee that the estimates will be achieved.

SGO also focused on external growth opportunities, spending €4.3billion on three value-creating acquisitions over the last three years. It acquired Continental Buildings in Nov 2019, Chryso in May 2021 and signed a definitive agreement to acquire GCP Applied Technologies in December 2021. These acquisitions are contributing over 4% to group sales and 6% to EBITDA (earnings before income, taxes, depreciation, and amortization), and SGO is expecting to create meaningful synergies from these purchases over time. As part of its external growth strategy, SGO is targeting sales growth of 1–2% per annum with attractive synergies in operating cashflows — it has budgeted €5bn for this purpose in 2021–25.

EU Renovation Wave to Drive European Construction Market

Europe's building stock is old. More than 220 million building units, representing 85% of the European Union's building stock, were built before 2001 and have an average age of more than 40 years. Of the existing buildings, 85–95% will remain standing in 2050 and most of them are not energy-efficient. Buildings in Europe account for 40% of energy consumption and for 36% of the region's greenhouse gas emissions from energy. Energy poverty is a widespread problem across Europe.

Figure 4
Europe's Homes Are Getting Old



Source: Alphawise, Morgan Stanley Research as of 31 December 2021.

Renovation is the key to reducing the energy consumption of buildings, which in turn brings down emissions and reduces energy bills. The European Commission proposed in the Climate Target Plan 2030 to cut net greenhouse gas emissions in the EU by at least 55% by 2030 compared to 1990. Building renovation is an essential component for the EU to reduce buildings' greenhouse gas emission by 60% to achieve the 2030 target. It aims to effectively double the energy renovation rate from the current level of 1% to 2% by 2030.

In 2020, the EU announced its ambitions with its recovery fund and EU Green Deal to drive a post-COVID recovery in Europe that is fully aligned with its climate goals. The European Commission estimates there is an annual funding shortfall of at least €470bn to achieve Europe's climate goals. Building renovation is one of the areas facing the largest investment gap — the EU estimates €275bn additional investment per year is required to double the annual building renovation rate by 2030, which represents an increase of more than 30% on 2019 private renovation in Europe. Recovery and Resilient Facility (RRF), Multiannual Financial Framework (MFF) and private investments through InvestEU are schemes that encourage various climate action plans, including building renovation in EU, encouraging EU member states to grant stimulus programs to support energy renovation.

Recent amendments to the Energy Performance of Building Directive (EPBD) incentivize building renovation as it requires all new buildings to be zero-emission by 2030. The amendments standardize energy performance certificates (EPS) across the EU and includes the region's first minimum energy performance standards (MEPS) for existing buildings. Under the EU Taxonomy Climate Delegated Act, building renovation is considered a sustainable activity where it achieves at least 30% energy savings. Both stimulus plans and regulations are tailwinds to the building renovation industry over the medium to long term. Stimulus plans reduce the payback period of renovation investment and regulations encourage renovation activity by improving real estate values.

SGO a Beneficiary of EU Renovation

SGO is a leader in Europe's renovation market and one of the key beneficiaries of the EU's renovation wave. Over 65% of its sales are from Europe and two thirds of that come from the renovation market. This renovation wave will favor all types of buildings, and SGO is well placed given its diverse product lines such as plasterboard, glass wool, double-glazing windows, insulation solutions to flooring and roofing etc. About 72% of its total sales are in the area of sustainable solutions — the company's products can help to reduce energy bills by as much as 70% , comply with regulations, and can boost renovated property values.

SGO is witnessing strong renovation-led demand, especially from France, Spain and Italy. It has created a one-stop solution renovation platform '*La Maison Saint-Gobain*' where customers can get all the information they require on renovation-related questions from qualified professionals. SGO's considerable footprint, strong brand, and booming trends in European renovation provides support for the firm's prospects — the company said it expects volumes to grow by 4–5% over the near term.

Our Confidence Quotient Assessment

SGO scores well in our proprietary Confidence Quotient (CQ) framework. Company management have profoundly changed the business strategy with a successful rationalization of the lower margin distribution businesses. We have also become more confident that SGO can capture sustainable growth opportunities in the European building renovation market. Furthermore, we believe their G&I strategy to enhance operational excellence should drive margins from high single digits to low double digits. These management actions led us to raise the Management, Financial Condition and Market Position CQs, positioning the company as a leading player in the European building products market with strong pricing ability in an inflationary environment.

SGO's strategy in economic, social and governance (ESG) issues is very clear; it wants to maximize the positive effect of ESG factors for its customers through the solutions it offers, while also seeking to minimize its own carbon footprint. According to SGO, the solutions it sold in 2020 avoided 1,300 million tons of emissions for customers, which is equivalent to 40 times the group's carbon footprint. It was also the first EPD (Environmental Product Declaration) issuer in the industry, issuing about 1,500 of them in 2020. With regard to minimizing its own carbon footprint, SGO is aiming to reduce scope 1 (direct) and 2 (indirect) emissions by 33% in 2030 versus 2017, and is committed to achieving carbon neutrality by 2050.

Conclusion

Saint Gobain trades on an enterprise value (EV) to EBITDA multiple of 7.0x, a valuation that we believe to be relatively attractive and which represents a meaningful discount to our sum-of-the-parts valuation multiple of 12.0x. We see potential for the valuation to gradually improve over time. The company is well positioned to participate in the EU renovation wave, and its continued focus on performance delivery — which has been evident over the past two years — along with improved governance, high exposure to the less-cyclical renovation market, and the potential for a valuation re-rating all contribute to the relative attraction of investing in SGO.

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Endnotes

1 Net Zero Tracker (https://zerotracker.net/).

2 The TSVCM is a private-sector-led initiative working to scale effective and efficient VCMs to aid in meeting the goals of the Paris Agreement. The TSVCM's over 250 member institutions, represent buyers and sellers of carbon credits, standard setters, the financial sector, market infrastructure providers, civil society, international organizations and academics.

3 An agreement on Article 6 of the Paris Agreement at COP26 lays down the rules governing the operation of a global carbon market. An agreement on Article 6.4 (creating a new international carbon market) and Article 6.2 (the supporting framework for country-led trading schemes) resulted in the formation of a rulebook for what qualifies as a carbon credit and its usage- meeting a country's emissions reduction target under the Paris Agreement, industry led offset-scheme, or voluntary carbon markets.

4 CDP (2021). Putting a price on carbon: The state of internal carbon pricing by corporates globally.

5 A shadow price is a theoretical or an assumed cost per ton of carbon emissions based on the climate objectives. When emissions bear a cost in profit-and-loss statements, it helps to uncover inefficiencies and incentivize low carbon innovation within departments, cutting a company's energy use and carbon emissions.

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- Invent the future

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* Pensions & Investments Research Center, as of December 31, 2020.
† This figure is presented as of March 31, 2022 and includes approximately $73.35 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.

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