For Professional Investors and Advisers Only

February 2021

Global Musings
Volume 9

RWC Global Horizon

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Global Musings Vol. 9 | February 2021

Contents

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Head of Global Equities

Global Horizon

Louise joined RWC in April 2013 to establish the RWC Global Horizon Strategy. Louise and her team seek out equity investment opportunities from around the world with little regard for the benchmark and a focus on the supply side of industries. The team's multi-year time horizon allows them to identify businesses whose share prices are trading at a fraction of their intrinsic value. Alignment of interest runs throughout the strategy: the team not only aims to align itself with its end clients but also emphasises the importance of alignment between shareholders and management company.

Louise was previously Global Portfolio Manager at Marathon Asset Management, and was at Clerical Medical (later known as Insight Investment) before that.

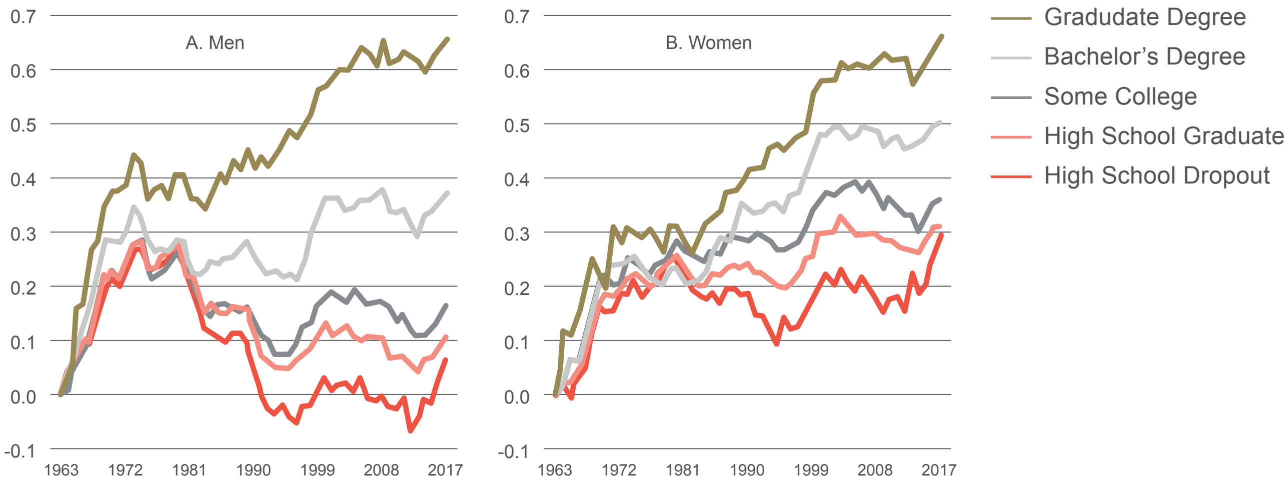
Introduction: Challenges and opportunities ahead

"Education is the passport to the future, for tomorrow belongs to those who prepare for it today"

Malcolm X

With interest rates at historic lows, governments entered 2020 with little to no dry powder to address the next economic recession. Little did we know that a global, natural disaster was among us. The pandemic has stolen the sunset years from the elderly and the livelihoods from many. It has also amplified the income inequality within countries with furloughed and redundant workers often from lower paid roles in the hospitality and retail industries. At the same time, public sector and blue collar workers have often been the ones who have faced the pandemic head on while higher paid roles have hunkered down in the relative safety of their homes. Of course, behind the allocation of roles within an economy lies a tale of social (im)mobility and education. Most worryingly, the pandemic looks set to amplify those inequalities for the next generation with home schooling being a poor substitute for the in-person participation particularly for poorer households, with limited access to devices and space to learn. It also leaves the most vulnerable children without the safeguards which vigilant teachers provide. As Figure 1 shows, one of the largest determinants of income inequality is the level of education. The importance of university education to income levels has increased significantly since the 1980s. It also suggests that some workers are not fulfilling their potential as individuals who had the ability to get a place at college earn little more than the "High School Dropout". The lack of real wage growth, and for some cohorts real wage declines, fits with what we know of labour's declining share of GDP in recent decades.

FIGURE 1:
Cumulative change in real weekly earnings of working adults aged 18-64



Source: American Economic Association, The Great Demographic Reversal by Charles Goodhart and Manoj Pradhan, 2020.

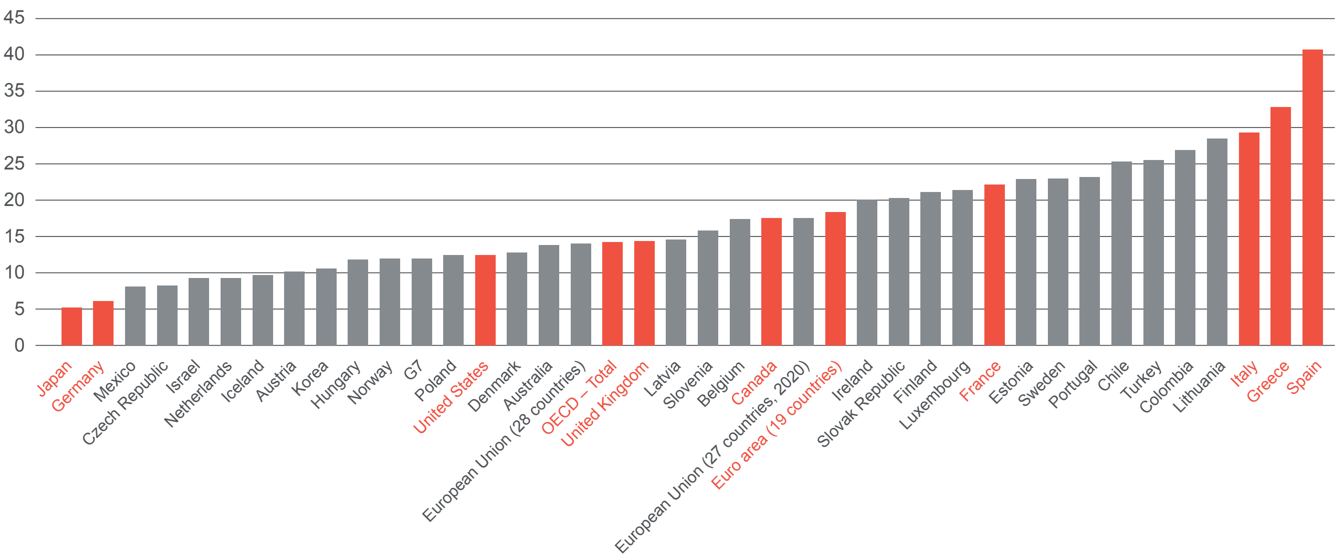
RWC

Income inequality and the inability for workers to be redeployed has been one of the factors behind growing nationalism around the globe and populist politics of recent years. The unprecedented fiscal support for workers during the pandemic may be sufficient to keep higher unemployment at bay before herd immunity (from infection and vaccination programmes) allows a re-opening of economies. For us in the Northern hemisphere, it is easy, in the dark days of January, to focus on the potential shortcomings of the vaccines. How will they fair against new strains? Are we poised to be chasing an ever-mutating virus? However, the up cards are beginning to outnumber the down cards. The virus has remained most perilous for the elderly and those with pre-existing conditions; the global pharmaceutical industry has delivered a number of fully tested vaccines within 12 months of the discovery of the virus; firms have been able to adapt to remote working in a way which was possible technologically for some time, but was culturally unacceptable. Scientists continue to believe that the vaccines will be effective against new strains. So, we will follow the science and believe that we are on course for improving economic conditions. Consequently, some of the most attractive investment opportunities have a cyclical component to them and often where the sector is likely to exit this period more consolidated than it entered.

From a social perspective, there is the potential for society to embrace more flexible work practices and improve workplace diversity as less frequent commutes engage underpenetrated parts of the workforce such as parents returning to work and the handicapped. However, one of the greatest challenges for governments will be to ensure that workers who were displaced during the pandemic have the opportunity to retrain and re-enter the workforce. Huge swathes of 15 to 24-year olds seeing little prospect of employment is not a recipe for social or political stability.

FIGURE 2:

Unemployment rate by age group 15-24-year olds (%)



Source: OECD, December 2020

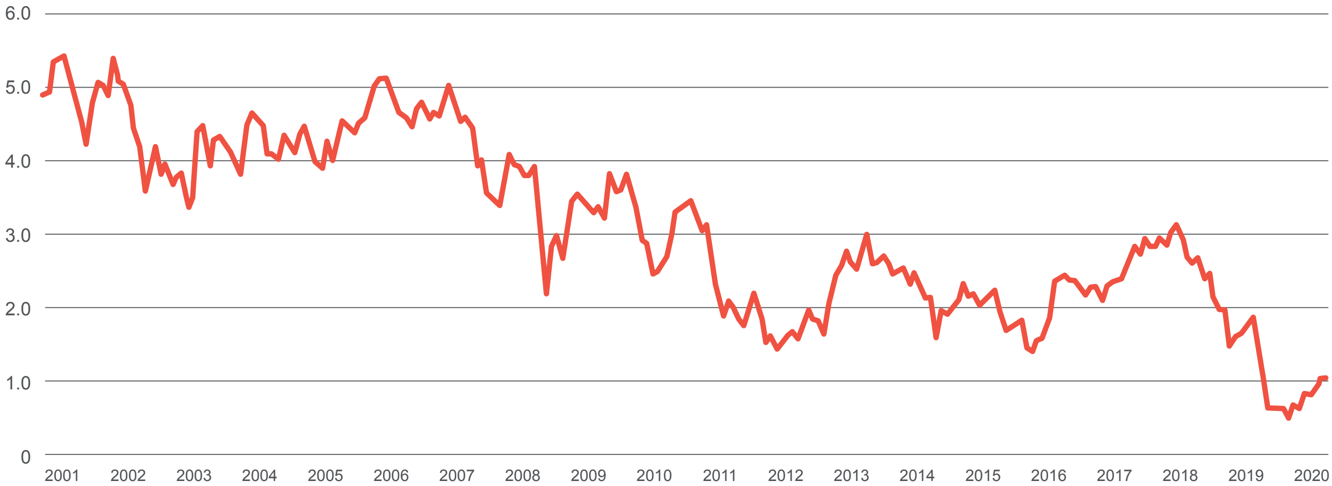
No investment strategy or risk management technique can guarantee returns or eliminate risks in any market environment.

Governments all over the world leave this crisis with a heavy debt burden. With interest rates at historic lows, the economic rationale for support is easy to make (on top of any social or moral justification) if it allows the economy to reignite faster. However, will this weight of debt encourage governments to reassess what constitutes a desirable level of inflation? Inflation penalises savers and favours borrowers. Governments have an incentive to be more comfortable with inflation if it diminishes the real cost of debt. Will central banks feel compelled to respond with higher interest rates and thereby increase the servicing cost of debt? It seems to us that determining the appropriate level of inflation is likely to become an increasingly political debate.

Any signs of an economic recovery are good news for banks. 19% of the portfolio is in financials (for reference, the sector constitutes 13% of the MSCI ACWI (vs. over 21% between 2012 and 2015). The US 10-year yield has bounced from a low of 0.50% in August 2020 to 1.1% on the back of greater confidence that light is at the end of the pandemic tunnel. However, we do not believe that economic recovery or any rekindling of inflation is priced into the share price of banks.

FIGURE 3:

US 10 year yield (%)



Source: Bloomberg, February 2021

Post the Global Financial Crisis, the approach for banks to recognise credit risk was overhauled. This has led to the introduction of IFRS9 and FASB's[1] CECL (Current Expected Credit Losses). These accounting standards have moved from the incurred loss approach to requiring banks to make timely reserves based on expected losses over the life of their existing book of business. Consequently, we saw significant reserve builds by banks in the second and third quarters of 2020 so the rainy day fund was set. Any further reserve build would require a significant deterioration in the economic outlook and therefore the probability attributed to the severely adverse scenario. Not only has this approach enabled banks to illustrate that they have the liquidity as well as the capital to weather any credit storm but also, it has given Mr Market greater visibility on the credit profile of banks relative to their peers. By most banks adopting Moody's economic outlook or a more conservative scenario, it has enabled investors to get a better understanding of the risks within the current book.

1 Financial Accounting Standards Board that sets GAAP accounting standards.

Curtailing individuals' ability to spend money due to lockdowns and government support has bolstered household savings and muted credit losses so far. Indeed, JP Morgan released $2.9bn of reserves in the fourth quarter of 2020 (having added $15.2bn over the first three quarters of the year[2]) due to the improving credit outlook. Citigroup similarly released reserves which "reflects our improving macroeconomic outlook" leaving "$28bn in reserves, which represents an allowance for credit losses of roughly 4% of funded loans". So, the greater challenge for banks is of profitability in an environment of abundant liquidity, low interest rates and higher capital requirements.

Regulators have also dampened the ability for banks to return surplus capital to shareholders through dividends or to buy back their shares. This is one of the reasons we were pleased to see the acquisition of TCF by Huntington Bancshares and Caixabank's purchase of Bankia. Both transactions are in market; remove a competitor and enable the banks to leverage IT and compliance costs. Making a virtue of a crisis is a trait we admire in companies. Any increase in interest rate expectations in a recovering economy would provide significant upside from current expectations but in the interim, the banks look well capitalised and attractively valued for all but the most dire of scenarios which even in the depths of a British winter seem unlikely.

2 Leaving $30.8bn of reserves ($21.6bn of which are attributed to the Consumer segment).

RWC Global Horizon ESG report 2020

Our ownership mentality has always focused our minds on business sustainability. Balancing the interests of stakeholders is a key responsibility of company management and asset owners need to encourage and support them in this mission. Over the years of managing assets in this way, we have concluded that the highest perceived risk areas of the market are not necessarily the areas of greatest concern as the risks may be well managed and mitigate to a greater extent than other 'cleaner' businesses. Deeming industries 'dirty' or 'clean' however fails to consider the difference between the inherent risk and the scope that exists for company management to manage those risks effectively. Consequently, deeming sectors as 'uninvestable' risks starving engaged management of capital to make improvements to their businesses which would help them become more sustainable. This in turn encourages companies to go private where disclosure standards are, broadly speaking, lower and the risks to society more likely to go unnoticed.

It is for this reason that we avoid blunt scoring systems within our approach and instead focus on the key risks to a business' sustainability, how management is incentivised to manage these risks, and understanding the effort that goes in and the performance that is delivered.

An insatiable desire to understand and an ability to apply critical thinking skills are requirements of being an investor. So, we are always keen to understand other perspectives. In this report, we have taken the independent assessment of company ESG risks from Sustainalytics and used it to challenge our understanding of the risks inherent in a business (Table 1) but also net of management's actions (Table 2). We have then reviewed the available carbon data for the portfolio as a whole and for individual holdings. The portfolio level data is as at end of September 2020 and is weighted. Exposure to certain sectors has a huge impact on these scores and portfolio changes can mask improvements or deterioration in ESG performance at the company level. Furthermore, the carbon data needs to be properly understood to be insightful. Are emissions low because a company outsources some of the more carbon intensive functions which fall out of scope 1? Does it buy its way to lower emissions using credits? We believe that it may be more interesting to consider the carbon footprint of a company versus its peers to assess the impact of management's actions and whether all mitigating actions are being taken.

The availability and quality of data is key and we have a role to encourage increased disclosure. Global norms differ enormously as do levels of engagement across the range of relevant environmental, social and governance risks. The US, for example, is leading the charge on employee diversity but is a laggard on environmental considerations relative to asset owners in Australia and the Nordics. We see all companies through the same global best practice lens and recognise that local perceptions of this may differ wildly. For example, the combination of Chair/CEO roles is commonplace in the US; it is unthinkable in many other jurisdictions though. In such situations, we look for the source of robust challenge and ensure that management are aware that they are falling short of best practice globally. Similarly, in relation to the requirement for Modern Slavery statements; we want to see safeguards in place to protect workers regardless of legislative requirements.

All analysis requires good data. Shareholders have a responsibility to keep pushing for better disclosure, recognising that it is a huge undertaking for many of them. We need to commit to help organisations on the journey of greater sustainability regardless of their starting point.

Sustainalytics – Highest Company Risk Exposures

There is limited disclosure on how Sustainalytics derive their ratings for component ratings. So, we have provided our insights into the investee company's ESG risk profile and the steps the company is taking to improve.

Holdings ranked by highest Gross[3] Risk Score

<table>
<tr><th>Company</th><th>ESG Risk Exposure (Gross)</th><th>Managed Risk</th><th>ESG Risk Score (Net)</th><th>E</th><th>S</th><th>G</th><th>Sub-set Rank</th><th>Momentum</th></tr>
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<tr><td>APL Apollo Tubes[4]</td><td>69</td><td>19</td><td>50</td><td>–</td><td>–</td><td>–</td><td>72/142</td><td>-6</td></tr>
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The company engages in industrial manufacturing in a market (India) with weaker regulatory and legal controls over practises and standards. We have spent considerable time with the company to understand their culture and procedures for their manufacturing processes and labour standards in order to effectively manage risk i.e. chains of command, incentives, and how standard operating procedures are developed and enforced. APL has made the proactive step of commissioning an independent ESG report from Ernst and Young, which we believe reflects the company's desire for honest self-assessment and for continued improvements. The founder of the company remains in charge of day-to-day operations, and owns 38% of shares, making him fully aligned with minority shareholders in prioritising sustainability and protecting the firm's reputation. Actions taken so far for Environmental improvements include the use of renewable energy at plants, a 20% reduction in material wastage due to process efficiencies, and the use of recycled water. In many instances the proactive steps being taken by this company are not publicised externally and it is only through our engagements that we have become aware of them.</td></tr>
<tr><td>Anglo American Platinum</td><td>67</td><td>41</td><td>26</td><td>11</td><td>9</td><td>5</td><td>2/30</td><td>-5</td></tr>
<tr><td colspan="9">GH Comments
The company does have inherently high-risk exposure as a miner with activities being located in South Africa, where health and safety performance has historically been poor for this industry. However, Anglo American Platinum has one of the best ESG scores amongst its global peer group as they are actively manging their risk exposure so effectively. Anglo American Platinum is very focused on its health and safety risk whether it be in-mine safety measures, health monitoring of workers, family housing projects near the working mines and financial literacy education. Community projects are embarked on and then subsequently reviewed and evaluated with the community. Environmental risk, namely energy consumption/GHG emission and water usage is also managed actively. In water, their focus is on implementing operational and regional water balances and managing the risks in partnership with regional stakeholders. In addition to the specific measures taken, they are rolling out the regional water strategy development for Limpoppo region. In energy consumption, the company had filed for government approval for solar generation for the Mogalakwena mines. It also plans to generate green hydrogen from the plant to use for the fuel cell haulage truck in the future. Their commitment to sustainability is underlined by 20% of senior executive's short term and long-term performance based renumeration has sustainability metrics.</td></tr>
</table>

3 Gross ESG risk can be seen as that inherent with the business before the actions of management.

4 Sustainalytics does not provide underlying E, S and G scores for these companies.

Company	ESG Risk Exposure (Gross)	Managed Risk	ESG Risk Score (Net)	E	S	G	Sub-set Rank	Momentum
Scotts Miracle-Gro	59	13	46	20	16	10	24/52	0
GH Comments Some of the company's lawn and garden products have been associated with having a negative impact on both the people that use them and the environment. For example, in 2019 the company was fined c. $100m for knowingly selling wild bird food treated with a pesticide which was known to be highly toxic to birds. The company is also the exclusive marketing agent of Bayer's RoundUp in the US, and uses glyphosate in its own product Ortho GroundClear Vegetation Killer. The company has now removed ingredients like neonics and phosphorous in their products to reduce the negative impact on waterways and wildlife and has also improved the clarity of labelling and instructions in order to avoid over-use by consumers, which would otherwise amplify the environmental and human impact. They are also investing in organic and natural ingredients for products, which has incidentally become one of the fastest growing categories for the company. In their Hawthorne business segment, which sells hydroponics equipment, there is a social risk that the company's products are facilitating the illegal cannabis industry. The company has told us this is difficult to gauge, given the limited visibility they have into where their product ends up. One mitigant of this risk is that the direction of travel is towards decriminalisation and legalisation of cannabis use across the US. After the 2020 election, there are now only six states in which cannabis is illegal in all forms, representing 7% of the population. Conversely, there are keen advocates for the medicinal benefits of cannabis. The company is working to improve its ESG disclosure, which should increase investor visibility further into how they manage risk. The company has identified five areas that are key to its sustainability strategy in August 2020, which include product stewardship and safety, and intends to share more around specific targets and timeframes in future reports.								
American Airlines	52	21	31	11	14	6	24/71	-1
GH Comments The US airline industry is an inherently emissions-intensive industry. American partially mitigates its environmental impact by flying one of the youngest fleets in the US; its carbon emissions per USD of revenues are below the global median for airlines. The company has a goal to reach zero net emissions by 2050. Initially, the method to begin to offset emissions will be through carbon offsets. By 2050, the company estimate around 50% of the improvements will come from levers outside of the company's control, like next-generation aircraft, air traffic control modernisation and sustainable aviation fuel. Around 25% will come from carbon offsets and around 25% will come from levers under American's control, like fleet renewal and flight operations and efficiency. The company has committed to source 2.5m gigajoules of cost-competitive renewable energy by 2025 to support the development of the sustainable aviation fuel industry. There are no ESG targets included in management compensation at present. American Airlines has also worked to improve the relationship it has with unions, and the industry has increased pay.								
Citigroup	50	24	26	1	11	13	93/389	1
GH Comments Sustainalytics attributes the high social risk to Business Ethics issues, relating to multiple allegations of market manipulation and shortcomings in AML controls, which have resulted in significant fines and compensation payments. Given the continual occurrence of incidents across a range of departments (Libor, Forex, ISDAfix, US Treasury Futures) as well as money laundering allegations, Citi needs to improve its culture and controls at a system-wide level. In response, Citigroup have been making continued investments into the divisions, with compliance team headcount increasing from 14k people in 2008 to 30k now, and have hired a new Chief Compliance Officer in 2020. This should help improve internal controls and processes. Citigroup is continuing its investments in this area further, with the new CEO prioritising transformation of their risk controls and compliance as one of her two key objectives. Citi expects its growth in operating expenses to be ahead of growth in revenues next year due to these investments; it is encouraging to see management prioritising investments in compliance infrastructure over near-term profitability.								

Company	ESG Risk Exposure (Gross)	Managed Risk	ESG Risk Score (Net)	E	S	G	Sub-set Rank	Momentum
GlaxoSmithKline	49	28	22	2	12	8	6/383	-4
GH Comments Since the bribery incident between 2007-2013, they have implemented mandatory anti-bribery and corruption training courses for its employees with more in-depth courses tailored for employees in high-risk areas. They also have a whistleblowing scheme with confidentiality assured. GSK has not been involved in any additional significant incidents on false and deceptive marketing and product safety disclosure, both of which occurred before 2012. They have strongly managed their other key risks. As a pharmaceutical company product quality is a key risk in their business. Here they comply with relevant regulation and best practices. In 2019, 196 external regulatory inspections were conducted at their manufacturing sites and local operating companies with no substantial issues. They also conduct audits of their suppliers' quality processes and clinical studies. Through their efforts to ensure affordability, especially of vaccines in developing countries, they are actively managing their business ethics, which is another risk area for the company. GSK aim to reach 800m people in developing countries in need of their products by 2025.								
Paccar	48	13	35	8	17	9	45/109	0
GH Comments Paccar needs to improve its disclosure in the areas of human capital and occupational health and safety more detailed information on its discrimination policy, diversity programmes and talent development programme. In the key risk area of workplace safety, they have substantially lower than industry average recordable injury/illness rate which demonstrates that their health and safety measures are executed well. We are encouraging the company to make further public disclosure around its health and safety management, such as the external health and safety audits conducted on a regular basis. In managing environmental risks, senior managers are part of an internal reporting structure for environmental performance. 88% of their facilities are ISO 14001 certified. Paccar is actively managing its scope 3 emission risk by its line-up of Battery Electric Trucks (which are available to purchase) and actively working on the Fuel Cell Trucks.								
Nissan Chemical Co	48	23	25	11	5	9	2/44	1
GH Comments Nissan Chemical has high ESG risk exposure due to the inherent Environment risk in chemical manufacturing (e.g. air pollutants, hazardous substances, wastewater, emission from energy used in its production), and the hazards of working in such an environment. At their Toyama plant (their largest plant) they have switched feed stock for ammonia from naphta/heavy oil to natural gas in 2016, and fuel for melamine heating furnace from heavy oil to natural gas in 2017, both contributing to a reduction in GHG emissions. Approximately one third of the Toyama plant's electricity generation is from hydroelectric power, and they have solar panels installed on their Biological Research Laboratories which is expected to reduce GHG emission by 70 tons CO2 p.a. As result of their active management their GHG emission Scope 1&2 have declined by 25% (measured in CO2 tonnes) and are ahead of their 5 year target, set in FY16. Health and safety is also actively managed with dedicated health and safety teams in their plants reporting directly to the CFO demonstrating that health and safety aspect is well integrated into their business strategy.								
Caixabank	48	25	23	2	8	13	41/389	3
GH Comments While Caixabank's governance score appears weak in absolute terms, Sustainalytics ranks Caixabank's governance as being high (in the 88th percentile) amongst Southern European banking peers. The key issues Sustainalytics highlights is that Caixabank is currently under investigation for involvement in the laundering of €99m by Chinese criminals during 2013-15, by not following AML protocols. There have been no other similar incidents of AML breaches across Caixa, and this has so far been an isolated occurrence for the company. Furthermore, Sustainalytics highlights that BPI, a Portuguese subsidiary, has been fined for anti-competitive lending practises between 2002-13; however we note that these were industry-wide fines imposed on 14 banks in total, and occurred prior to Caixa's acquisition of BPI.								

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Holdings ranked by highest Net[5] Risk Score (net of managed risk)

Company	ESG Risk Exposure (Gross)	Managed Risk	ESG Risk Score (Net)	E	S	G	Sub-set Rank	Momentum
APL Apollo Tubes[6]	69	19	50	–	–	–	72/142	-6

GH Comments

The company's inclusion toward the top of this table implies that it not only has a high level of inherent risk, but that these risks are being poorly managed. For APL Apollo, our analysis and engagements have shown the company to be incredibly proactive on ESG, however the company does not report much of this externally, as explained in the prior table. Many positive steps have already been taken, including the incorporation of renewable power at production plants (wind and solar PPAs, as well as their own solar panels at the plants), switching feed oil from furnace oil to gas, reducing wastage at plants by 20% and full use of recycled water and water effluence treatment plants at all facilities. The company has now commissioned Ernst and Young to do a full ESG assessment, covering all of the company's manufacturing sites. The company has shown a desire to understand and address ESG risks. We look forward to a detailed discussion with the company on its findings when the report is released in early 2021. We would further note that the founder of APL Apollo is still running the business, and currently owns 38% of the company. He is therefore well-aligned with minority shareholder to prioritise protecting the reputation of the company and ensuring its long-term sustainability.

Company	ESG Risk Exposure (Gross)	Managed Risk	ESG Risk Score (Net)	E	S	G	Sub-set Rank	Momentum
Scotts Miracle-Gro	59	13	46	20	16	10	24/52	0

GH Comments

The company's inclusion toward the top of this table implies that it not only has a high level of inherent risk, but that these risks are being poorly managed by the company. Sustainalytics' assessment that Scotts' overall ESG-related disclosure is not in accordance with GRI reporting standards and is "lagging behind best practice" is outdated given they have now published a report which is in accordance with GRI reporting standards (in August 2020). However, in that report Scotts didn't disclose any specific numerical targets, so assessing whether they are appropriately managing their material ESG risks (Sustainalytics' other main issue with Scotts) is more about evaluating the qualitative statements they've made.

The issues they face are inherent to their product portfolio, given they sell pesticides and weed killer which are designed to be harmful to specific parts of the natural environment. RoundUp is the biggest environmental risk they face. The company believes that it was human error from overuse that primarily caused the issues and when properly used the product is safe. They have tried to manage these risks through better labelling (both on proper use and on transparency on whether the product contains glyphosate) and removing glyphosate from their own weed killer. They have also removed other higher risk active ingredients (although this has been reactive to when a state law changes rather than proactive). They also mention in the report that they are 'introducing life cycle assessment tools to help evaluate sustainability impacts while optimizing our existing products and spurring innovation in new product design', which implies they intend to take the potential environmental impact of their products more seriously.

Our conclusion is that there is still a lot more they could do to demonstrate proper management of their inherent ESG risks in a proactive manner. We remain engaged with them on these issues.

Company	ESG Risk Exposure (Gross)	Managed Risk	ESG Risk Score (Net)	E	S	G	Sub-set Rank	Momentum
Eagle Materials	45	9	37	21	7	9	63/114	0

GH Comments

The largest contributor towards Eagle's Environmental score is the Carbon output of their operations. Although Eagle Materials has a high level of carbon intensity, this is inherent to its business activities. When viewed alongside global peers operating in the same sub-sector, Eagle's is comfortably within the better performing half of its global peer group on carbon intensity, suggesting effective management actions. The other Environmental consideration for this industry is the use of CKD (cement kiln dust) which is classified as a hazardous material under certain circumstances. All the CKD used at Eagle's plants is recycled, and therefore is considered as non-hazardous by the regulatory agencies. The company is currently conducting a Sustainability report which has been delayed due to Covid-19. The company is also currently working to separate its two businesses , Cement and Wallboard, which could encourage greater focus on the sustainability of operations by management.

5 Net ESG risk can be seen as the risks the business is exposed to after the actions of management to offset risks inherent in the business model.

6 Sustainalytics does not provide underlying E, S and G scores for these companies.

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<tr><td>Mandarin Oriental[7]</td><td>40</td><td>7</td><td>33</td><td>–</td><td>–</td><td>–</td><td>98/130</td><td>–</td></tr>
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The company has significantly improved its ESG disclosure in 2020, providing auditable metrics to track progress. Mandarin Oriental sets targets around the reduction of its energy intensity and water intensity per square metre by 20% vs a baseline of 2007 and a 25% reduction per square metre in its GHG emissions vs 2007 and waste vs 2012. It has also committed to the elimination of single-use plastic by March 2021.

The company has made consistent progress in reducing its GHG emissions, with visible annual improvements, as well as growing diversion of its waste away from landfill, which has doubled since 2012 from 18% of waste to 45% in 2019. However, its progress on reducing water and energy intensity has stalled since 2012, with no progress shown on either of these measures since then. The primary way the company reduces water intensity is appealing to guests to use less, rather than changing its own water management approach at present.</td></tr>
<tr><td>Onex</td><td>44</td><td>11</td><td>33</td><td>3</td><td>15</td><td>15</td><td>157/331</td><td>17</td></tr>
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Onex is a Sustainability Accounting Standards Board (SASB) Alliance member and has also adopted the American Investment Council Guidelines, which guides how Onex systematically considers ESG risks and opportunities in potential investments.

Onex’s PE funds require all operating companies to develop, adopt and maintain effective ESG programs supported by annual reporting and certifications.

Onex set up an ESG committee in 2019, comprised of representatives from all Onex platforms and the corporate office, which is focused on enhancing the firm’s holistic approach to ESG.

All Onex investment platforms perform extensive due diligence and research on prospective investments to identify and address significant risks and opportunities, including ESG matters, using internal experts as well as external legal, environmental and/or other specialist advisors as appropriate. Onex also avoids investments which it believes to provide harmful or unacceptable products or services. There is significant alignment of interest between the partners and shareholders.</td></tr>
</table>

7 Sustainalytics does not provide underlying E, S and G scores for these companies.

No investment strategy or risk management technique can guarantee returns or eliminate risks in any market environment. The names shown above are for illustrative purposes only and are not intended to be, and should not be interpreted as, recommendations or advice.

Company	ESG Risk Exposure (Gross)	Managed Risk	ESG Risk Score (Net)	E	S	G	Sub-set Rank	Momentum
American Airlines	52	21	31	11	14	5	24/71	-1
GH Comments American partially mitigates its environmental impact by flying one of the youngest fleets in the US; its carbon emissions per USD of revenues are below the global median for airlines. The company has a goal to reach zero net emissions by 2050. Initially, the method to begin to offset emissions will be through carbon offsets. By 2050, the company estimate around 50% of the improvements will come from levers outside of the company's control, like next-generation aircraft, air traffic control modernisation and sustainable aviation fuel. Around 25% will come from carbon offsets and around 25% will come from levers under American's control, like fleet renewal and flight operations and efficiency. The company has committed to source 2.5m gigajoules of cost-competitive renewable energy by 2025 to support the development of the sustainable aviation fuel industry. There are no ESG targets included in management compensation at present.								
Toyo Tyre[8]	40	9	31	–	–	–	25/26	0
GH Comments As a tyre manufacturer the key risks are product safety, environmental impact of their tyre production (GHG emission from energy consumed in production, water usage), and health and safety of its workers. Their efforts to manage these risks are improving, mainly since 2018 when the current CSR working group was established with the (then new) CEO as the chairman of the working group. Having identified the key sustainability themes in 2019, they have been working on having their environmental data verified by a 3rd party to set credible long-term sustainability targets. Their current GHG emission (scope 1 & 2) target covers the period of 2005-2020 and only applies to their Japanese plants. However, they outperformed their target reduction of CO2 emissions, achieving a 20% reduction. Toyo has also improved the GHG emission per tire produced and energy consumed between 2017-2019, through various active efforts made by the company. They will disclose new targets this February at their new midterm plan announcement. We will review their new GHG emission targets and other targets such as use of renewable energy where we hope to see a specific programme around the issue. A notable improvement in their risk management has been in natural rubber sourcing which is one of their key raw materials. Toyo revised their supplier code in 2019 to bring it in line with the Global Platform for Sustainable Natural Rubber. In 2019 they undertook site visits of natural rubber supplier covering 80% of the usage volume. A significant part of their new product development is focused on more durable and energy efficient tyres which form part of managing their environmental risk. The takeaway from Toyo's Sustainability is that the starting blocks (the key themes identified) are good, that they are making progress and we are expecting to see more concrete target numbers in their new midterm plan.								
AIG	47	17	30	2	14	15	48/69	1
GH Comments Sustainalytics marks AIG down for not disclosing how it integrates ESG into its underwriting practices or investments portfolio, as well as lacking disclosure on Product Governance management systems, which includes marketing practices, fair billing, and post-sales responsibility. It was involved in a minor controversy related to product governance in a lawsuit with Puerto Rico in 2018, who sued because of delayed claims payments. AIG doesn't have any formal commitments on ESG and is clearly early stage in its approach to ESG. It appointed a Chief Sustainability Officer in 2019 and has launched a Sustainability Integration Team, which signals its intention to further integrate sustainability into its business practices. However, disclosure is poor and an area we want to see improvement in.								

8 Sustainalytics does not provide underlying E, S and G scores for these companies.

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Portfolio Carbon Emissions

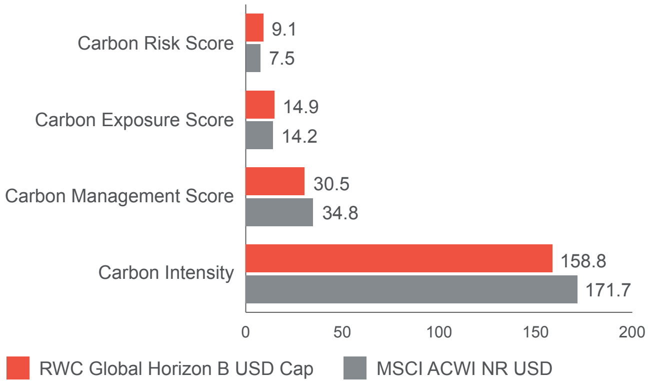
Approach:

This section presents carbon emissions data for the portfolio, both from external providers and the team's internal analysis.

The table on the left below shows the aggregate emissions data for the portfolio from Morningstar. The table on the right below is Morningstar's carbon risk scoring for the portfolio based on aggregate Carbon Exposure Score (i.e. the inherent carbon intensity of the investments in the portfolio) and the Carbon Management Score (how well the individual companies manage that inherent carbon risk) to provide a net Carbon Risk Score.

FIGURE 4:
Emissions.

Carbon Intensity – Carbon (metric ton)/Revenue (Mil USD)	159
Scope 1 – Direct (MMT)	2,049,709
Scope 2 – Indirect (MMT)	1,149,658
Benchmark Scope 1 – Direct (MMT)	3,282,302
Benchmark Scope 2 – Indirect (MMT)	1,299,864
Portfolio vs. Benchmark Scope 1	-38%
Portfolio vs. Benchmark Scope 2	-12%



Source: Morningstar 30/09/2020

The chart on the left tells us that the RWC Global Horizon portfolio is 38% less carbon intensive than the Index at a Scope 1 level, and 12% less at a Scope 2 level.

As a reminder, Scope 1 emissions refer to direct emissions from a company's owned or controlled assets. Scope 2 refers to indirect emissions from energy purchased from external sources.

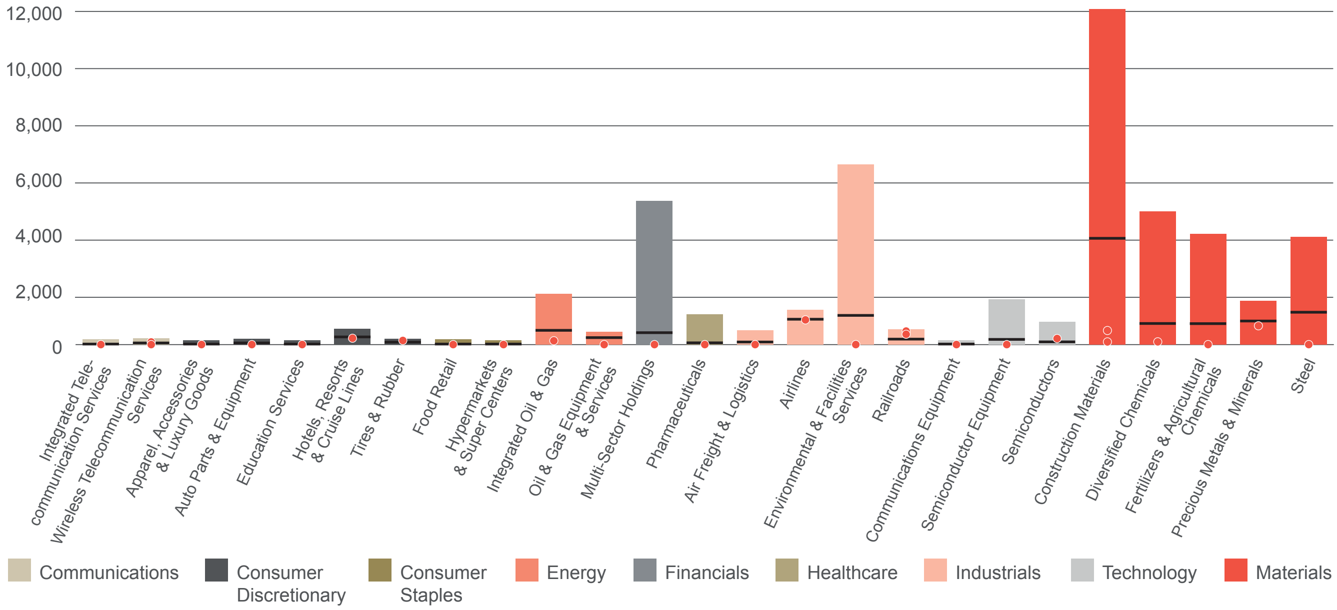
The chart on the right tells us that Morningstar believes the portfolio has a higher Carbon Risk score than the Index (i.e. more carbon risk), and that this predominantly stems from the individual companies not managing their inherent carbon risks well (shown by the lower carbon management score that the portfolio receives vs the Index). We supplement this with our own in-house analysis below where we look at the carbon intensity of all the constituent holdings within the portfolio relative to their global peer groups and make our judgements on the effectiveness of management teams in minimising carbon intensity and risks.

RWC Global Horizon Portfolio Holdings - Carbon Emissions (tonnes per 1mUSD of revenues)

Chart 1 (below) shows the sub-sectors within the portfolio for which carbon intensity is inherently higher within the business models. We would expect businesses operating in these sub-sectors to place a high priority on managing their carbon emissions and the Environmental risks associated with their carbon footprints. The red dots represent holding companies. The bars represent the distribution of global peers within the MSCI ACWI Index, with the black line being the median carbon intensity for that global sub-sector. By comparing our holdings directly to global peers who operate with similar business models, we can see with better context the extent to which management teams are effectively managing the carbon intensity inherent in their business operations. This also allows for a more informed and nuanced discussion with management teams on their approach to the issue.

FIGURE 5:

Carbon Analysis Higher Sub Sectors Contributions (tonnes per US$1M revenue)



Source: Company disclosures for 2018 aggregated via Bloomberg. In the absence of company disclosure, a Bloomberg estimate has been used. Estimates represent 18.9% of the MSCI ACWI universe.

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Holding companies with carbon intensity higher than global peer group median:

Railroads: Kansas City Southern (KSU) and CSX. Although KSU and CSX appear to be more carbon intensive than their global peer group, we would highlight that over half of the companies in the Railroads sub-sector are Japanese operators, which score well due to the electrification of those railroads. KSU and CSX's carbon efficiency is in line with their North American peers. Further, it is important to remember that transporting freight by rail produces 7 times less CO2 than by road freight transport, and 20 times less than airfreight.

Tires and Rubber: Toyo Tire. Toyo discloses its emissions in high granularity. They are promoting fuel conversion and equipment renewal in plants to reduce scope 1 & 2 emissions. However, they note that Scope 3 emissions are 85% of the tyre value chain. They are developing fuel efficient tyres to help offset this.

Semi-conductors: TSMC. TSMC has this year entered into power purchase agreements for 1.2GW of renewable energy. By 2030 TSMC wants 25% of the power consumed at its Fabs to be from renewables and 100% of its non-Fab facilities.

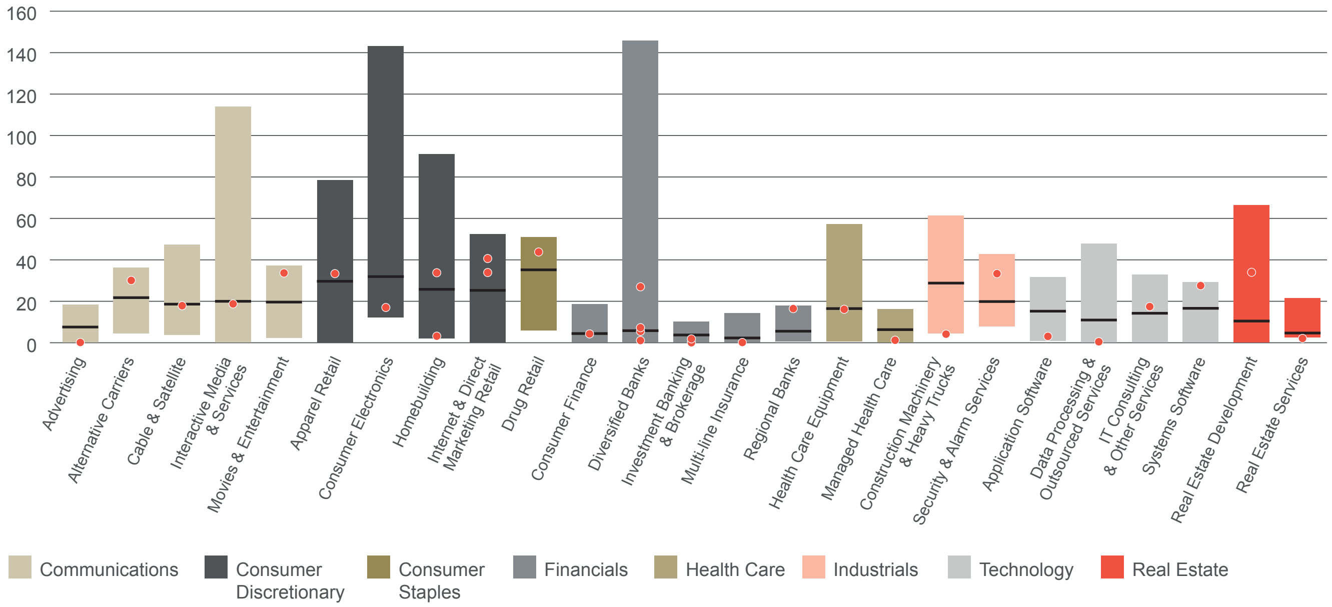
Wireless Telecommunication Services: Globe Telecom. Globe has committed to full disclosure of its carbon intensity by joining the Carbon Disclosure Project this year (the leading global environmental disclosure platform) and are part of an industry-wide group of telecoms companies aiming to hit net zero emissions by 2050.

Food retail: Kroger. Kroger's carbon emissions are only 2% higher than the global median implying that Kroger is managing its carbon risk in line with peers.

Chart 2 (below) shows the sub-sectors in which the portfolio is invested which have inherently lower carbon footprints. Although we are still alert to outliers within these companies and engage with management teams on carbon intensity, emissions tend to represent lower levels of risk for the companies given that they are at low absolute levels.

FIGURE 6:

Carbon Analysis Lower Sub Sectors Contributions (tonnes per US$1M revenue)



Source: Company disclosures for 2018 aggregated via Bloomberg. In the absence of company disclosure, a Bloomberg estimate has been used. Estimates represent 18.9% of the MSCI ACWI universe.

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RWC Global Horizon ESG Engagement Log

BP – Integrated Oil and Gas – UK

Date	Discussion Topic	Update and Outcomes
18/02/2020	A wide-ranging discussion on energy transition and broad ESG issues. Visibility on the strategy and targets is limited until the company hosts its September Capital Markets Day.	The company's September Capital Markets Day provided further detail on BP's low carbon aims and how it intends to achieve them. We were particularly encouraged by the fact that low carbon investments (which will account for >20% of capital employed by 2030) have clear and strict return on capital hurdles, as opposed to representing an exercise in greenwashing. BP continues to be an industry leader in energy transition. We subsequently added to our positions on the increased disclosure and greater confidence that capital allocation to renewables is tied to economic goals.

Anglo American Platinum – Materials – South Africa

Date	Discussion Topic	Update and Outcomes
25/02/2020	Louise Keeling (LK) and Miki Sugimoto (MS) met with the CEO (since 2014) before his departure and congratulated him on achieving zero fatalities for the year 2019. We also discussed their housing scheme for their workers which LK had recommended before and that we strongly endorse.	The CEO also informed us that they have reinstated RoCE as one of performance metric in their remuneration scheme which we had recommended in our previous meeting.
23/06/2020	Our first call with the new CEO. We discussed their holistic approach to ESG which we fully support. We congratulated them on increasing their performance metric weight to the sustainability factor in the senior management compensation scheme.	
17/08/2020	LK emailed the company to see if they have conducted an impact assessment on their housing and school projects and also requested their policy on modern slavery. The detailed reply from the company highlights how they are being proactive and the quality of their impact efforts.	They are a signatory to the UN Global Compact and a supporter of the UN Guiding Principles on Business and Human Rights. Their Code of Conduct articulates their position on modern slavery. Their group wide Anglo American Social Way 3.0 provides a framework for their site social performance management system and manages all human rights risks via its risk analysis tool. For their suppliers, they ensure suppliers embed the UN Principles of Business and Human Rights into their operations. They are specifically required to: commit to responsible business practices, complete self-assessment; provide evidence of third party assessment and manage risks.
29/09/2020	MS participated in Anglo American Platinum 2020 Independent Material Issues Assessment conducted by Ernst and Young on behalf of the company. We expressed our support for their approach to Sustainability, e.g. providing not just health and safety measures but financial training courses for employees to improve their financial literacy. We also supported the increasing sustainability weight in management's remuneration metrics.	We learnt about their education program "Lighting Tomorrow" which commenced November 2019, implemented in the 3 communities where their main mine operations reside. The aim of the programme is to encourage behavioural changes towards education. We were pleased to learn from their assessment on the project that the programme is resulting in rapid change in behaviour and improved academic achievement.
09/12/2020	MS participated in Anglo American Platinum Independent investor perception study conducted by Nasdaq. This call covered ESG aspects. We discussed Amplats' approach to sustainability, leveraging on their largest production mine being the lowest cost producer by being open pit and mechanised. They share the profits derived from their lower cost base by reinvesting in the local community, in order for the community to be sustainable.	

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Lazard – Financial Services – US

Date	Discussion Topic	Update and Outcomes
14/04/2020	A call to discuss issues raised by ISS regarding the firm's proxy statement for 2020, chiefly around management remuneration (and a repeat of the previous year's discussion). The conversation also touched upon the current composition of the board and succession plans.	We subsequently decided to vote against ratifying compensation for 2020 due to excessive levels of pay for CEO Kenneth Jacobs. The compensation package was subsequently approved at the shareholder meeting.

Telefonica – Communications – Spain

Date	Discussion Topic	Update and Outcomes
29/05/2020	LK, MH and Benjamin Hall (BH) spoke with Telefonica regarding their remuneration report for the upcoming AGM. We highlighted concerns over metrics used in the variable compensation plan, notably TSR, and excessive severance packages in place for the CEO. We indicated that we would be voting against the proposal. We also discussed Board size and composition, noting that we deemed it too large, and only just above diversity thresholds.	We voted against these proposals and will continue to raise them in future engagements. Particularly in an ESG-specific meeting scheduled for October 8th.
8/10/2020	BH spoke with the IR team as well as the Head of Corporate Governance and the ESG Non-financial reporting team from Telefonica. The entire call was given to ESG issues. The priority of our engagement was regarding Governance issues, in particular compensation, board size and composition, and capital allocation.	While Governance standards at Telefonica have improved significantly in recent years, we will encourage them to continue to strive for global best practises, rather than benchmark against their local peers or their own prior practices.

Live Nation – Movies and Entertainment – US

Date	Discussion Topic	Update and Outcomes
22/06/2020	We have tried to engage with Live Nation regarding the Poison Pill the company has in place.	The company was in quiet period during our first request. Subsequent emails have not received a response. In 2015 the company extended its Poison Pill for a further 10-year period. By providing continual feedback prior to 2025, we hope that management will not seek to renew the pill on expiry.

Nakanishi – Dental Equipment – Japan

Date	Discussion Topic	Update and Outcomes
08/07/2020	We have requested a meeting with the CEO owner to discuss how the company can use its very strong balance sheet for its long-term benefit during the current period given the pressure on the dental market.	An additional request was sent in September.
16/09/2020	In July LK wrote a letter to the CEO requesting a meeting to discuss company outlook. MS has followed up on this request twice.	MS to continue with request.

Scotts Miracle Gro – Materials – US

Date	Discussion Topic	Update and Outcomes
09/07/2020	A call to discuss Scotts Miracle Gro's approach to sustainability and the environment, after completing our in-house E&S research. The risk to Scotts' is the environmental impact of their products. The company takes a proactive stance on removing ingredients from its products when it believes they are leading to harm. The company believed that customer overuse was also sometimes to blame, and that they have attempted to address this through clearer labelling over the correct quantity to use. The company also highlighted that it was developing organic alternatives where possible, which have been very successful.	We were generally satisfied that the company is taking its products' impact on the environment seriously. We will continue to monitor Scotts' ESG disclosures, given they are at a higher risk from the nature of their products and some legal fines they've incurred in the past with bird feed poisoning. Significant family stake provides some alignment that management are mindful of maintaining the quality of the brand and reputation risk.

Cavco – Homebuilding – US

Date	Discussion Topic	Update and Outcomes
16/07/2020	MS confirmed with the company that Cavco had recently added a clawback policy to its management incentive program.	
10/11/2020	Call with CEO. MS noted that Cavco do not have a separate Sustainability report (social aspects are partly covered in the company's code of conduct rules) - the CEO noted that they are in the process of producing a sustainability report to be published in 2021	We will review the report, once released, and provide our feedback to the management team on its contents.

Eagle Materials – Cement – US

Date	Discussion Topic	Update and Outcomes
29/07/2020	We spoke with the company to highlight certain governance issues, notably: former executive on the board, lack of clawback policy, single trigger vesting of equity awards upon a change in control, and lack of shareholder right to call a special meeting/act by written consent.	The company admit that there are some areas of its corporate governance practices that require improvement, and that these are underway (including implementing a clawback policy), yet the planned separation of the Heavy and Light Material businesses remains their priority at present. The company confirmed that double trigger vesting is in place (ISS reports a single trigger policy). Management have readily admitted to the need to make improvements to its governance structures. We will continue to monitor and engage to ensure continual progress.

APL Apollo Tubes – Steel Construction Pipes – India

Date	Discussion Topic	Update and Outcomes
25/08/2020	BH and LK spoke with APL Apollo Tubes on their labour practices. We spoke with the Head of HR and Chief Strategy Officer on the controls and processes in place at plants, as well as the company's culture and values on employee safety.	The company sent a copy of the full HR Manual, which was received and reviewed by BH. They have commissioned Ernst and Young to conduct a full ESG report on their operations, covering all production plants, which should be released in early 2021. In spite of the proactive measures the company is taking to mitigate risks, we will continue to scrutinise the company given that they engage in industrial manufacturing in a market (India) with fewer regulatory controls over practises and standards.

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Mitie – Facilities Management – UK

Date	Discussion Topic	Update and Outcomes
25/08/2020	LK and Matthew Hannay (MH) spoke with Mitie Chief of Staff Peter Dickinson to discuss the company's approach to human rights abuse risks, including modern slavery. Peter explained the key areas of risk and mitigating steps taken by the company within its core businesses, namely cleaning and security - this includes a commitment to not bidding on contracts that do not pay the National Living Wage. (There is an exception with Government contracts who often will not pay above minimum wage). We also discussed Mitie's exposure to migrant detention centres, which although a small part of the business, does present high reputational risk. They also challenge Government on whether there are better ways to address the issue eg tagging.	LK and MH were been offered a tour of the company's Heathrow detention centre, which took place at the beginning of October.
07/10/2020	LK and MH conducted a site visit of the Colbrook Heathrow migration detention centre for which Mitie has the operating contract. According to employees, we were the first investors to request a visit.	Immigration detention is a small but potentially high risk area of the business, with failings at G4S's detention site at Gatwick airport being highlighted in a high-profile BBC documentary some years ago. The site visit provided comfort that the business is being managed responsibly, with Mitie providing training, better support services and higher compensation to workers to ensure responsible behaviour. They have also worked hard to support the mental well-being of detainees, for example by providing vocational training. They also challenge the Government on whether there are better ways to address the issue eg tagging. Government oversight is also on site at all times too.

Savills – Real Estate Services – UK

Date	Discussion Topic	Update and Outcomes
17/09/2020	MH spoke with Savills Group Legal Director Christopher Lee, to discuss the company's approach to human rights abuse risks, including modern slavery. While the risk is relatively low for much of the business, the property/facilities management business in the outsourcing of services such as cleaning, security, and landscaping, is an area of heightened risk.	Savills have a code of conduct that all suppliers must adhere to which ensures they are operating in line with local laws and regulations. The company has not received any reports of modern slavery occurrences, including through the anonymous whistle blowing channel. Staff are also required to take part in modern slavery identification training as part of their induction process.

Costco

Date	Discussion Topic	Update and Outcomes
16/11/2020	Following an update on the company's financial operations, we discussed with the company on how they police/monitor their vendors so that their E&S policy is adhered to.	They will renew their sustainability website in December which will contain more disclosure, in particular around environmental aspects.

BP: Investing in a greener future again?

The RWC Global Horizon strategy has been negative towards the energy sector since it's launch, due to the increase in industry supply, led by the shale revolution and improvements in renewable energy technology and storage, and the resulting re-fragmentation of the market. In addition, the energy sector has historically destroyed shareholder value as management have tended to extrapolate the prevailing commodity price and over-invest in new projects at the top of the cycle. We were attracted to BP for the fact the company seems to be taking a different approach, adopting through-the-cycle commodity price assumptions and switching from a volume to a value-driven mindset. Much of this is directed by management's conclusion that energy markets are structurally shifting towards low carbon and renewable sources, and their aim to turn BP into an integrated energy provider as opposed to a traditional fossil fuel company. As a result, we took an incubator position for the portfolio in October 2019.

Upstream business

The first step in the process of becoming an integrated energy provider is to increase the cash generation of BP's Upstream business, the company's traditional oil and gas exploration and production arm. The segment's annual capital expenditure has fallen from its 2014 peak of $19.1bn to just $9bn in 2020 as management has retrenched to core, less capital-intensive brownfield markets. Development spending will be focused on tiebacks (connecting new wells with existing production), and other near-hub options as opposed to developing new fields, while exploration activity, which has already fallen significantly from $3.6bn in 2014 to just $800m in 2019, should continue to come down with management recently committing to a freeze on exploration in new regions. BP is also pruning its asset portfolio, having identified $25bn worth of asset sales by 2025, concentrated in non-core markets where the company lacks the scale required to generate adequate returns. We believe that there may be an early mover advantage to pivoting the model now when there are likely to be more buyers of oil and gas assets than in the future, resulting in better pricing for asset disposals.[9]

These steps will result in a 40% reduction in oil and gas production and a 29% reduction in daily refinery throughput by 2030, alongside a lower breakeven point of $35 per barrel over time. BP has gradually moved down the cost curve and lowered capital intensity within its Upstream business and we expect that to continue.

As a result, BP's Upstream business should become a robust engine of cash flows that is less dependent on the commodity price than in the past, and in doing so help fund the company's strategic pivot away from fossil fuels and towards low carbon investments.

Renewables businesses

BP has dabbled in renewable energy previously, yet its much maligned "Beyond Petroleum" rebranding at the turn of the millennium was swiftly reversed after the departure of CEO John Browne in 2008. However, we are confident the company is now firmly committed to energy transition, underpinned by its aim of becoming a net zero company by 2050 or sooner, which will be achieved through a combination of lowering Scope 1 and Scope 2 emissions, reducing the carbon intensity of its marketed products and via materially increasing investment in low carbon projects.

It is worth remarking on the scale and ambition of these targets. Amongst the major integrated energy companies there appear to be two camps when it comes to energy transition, which can be split into 'leaders' and 'laggards'. The European majors have shown themselves to be the leaders, aligning themselves with the Paris Agreement and outlining clear plans to reduce the carbon intensity of their operations. This is in contrast to laggards such as Exxon Mobil and Chevron, who have so far displayed little concern for energy transition, failing to outline a low carbon strategy whilst doubling down on fossil fuels production. The table below captures the discrepancy in attitudes between the European and US majors:

9 Source: company filings (annual report).

Oil Majors Emissions Ambitions

Company	Scope 1 & 2 emissions	Scope 3 emissions	Financial framework
BP	30-35% reduction in Scope 1 and 2 emissions by 2030 with the goal of reaching net zero by 2050.	Net zero from operated production (excluding Rosneft) and 50% reduction in carbon intensity of all products by 2050.	12-14% return on average capital employed and 7-9% EPS growth (based on $50-60 Bren/bbl)
Shell	Aiming to reach net zero across Scopes 1, 2 and 3 by 2050, whilst reducing carbon intensity of products by 30% by 2025 and 65% by 2050.	Returns expectations not disclosed	
Total	Net zero by 2050	Net zero from products sold in Europe and 60% reduction in carbon intensity by 2050	Returns expectations not disclosed
ENI	Net zero carbon footprint within its upstream business by 2030, with a broader aim of reaching net zero for the group by 2040	Aiming for an 80% reduction in Scope 1, 2 and 3 emissions and a 55% reduction in emissions intensity by 2050	11% ROACE
Chevron	Aiming to achieve 5-10% and 2-5% lower GHG intensity from oil and gas production respectively from 2016-2023	n/a	>10% ROACE by 2024
Conoco Phillips	Net zero by 2050	n/a	Returns expectations not disclosed
ExxonMobil	n/a	n/a	Returns expectations not disclosed

Source: https://www.bp.com/en/global/bp-global-energy-trading/regulatory-disclosures.html as at January 2021

The most material part of the pivot is that BP is aiming for 50GW of installed renewable power generation by 2030, from just 2GW at present. The company is not starting from scratch, but rather will leverage its existing presence in solar, onshore and offshore wind and biopower, and has 20GW of development projects in the pipeline, with a further 21GW of early stage options. Moreover, BP estimate that were the company to achieve this 50GW target, this would only represent a low single digit percentage share of global renewables capacity by 2030, placing these ambitions in context of the broader shift to renewables.

Amidst fears that this is merely an exercise in greenwashing, it was encouraging to see management outline clear return on capital hurdle rates of 8-10% for renewables projects at the company's most recent Capital Markets Day. BP estimates that unlevered project returns begin at 5-6% and expect to push these upwards through a combination of leveraging the company's global scale advantages, deep expertise in project development and operations, and through selective use of gearing (given the lower starting point for returns). This is reassuring given the company is aiming for investment in renewables to increase from 2019 levels of $500m to $3-4bn by 2025, and $5bn by 2030, accounting for between 20-30% of total capital employed within the group. Nevertheless, we are aware that the return profile is uninspiring but we believe that there is scope for this to improve over time as technology is enhanced and expertise built.

Downstream business

BP's Downstream business arguably represents the company's most valuable asset, with strong returns on capital over time that are also less volatile through the cycle than its exploration and production activities. Downstream is the product and service-led arm of BP that includes refinery operations, lubricants and petrochemicals manufacturing, and the branded service station and convenience retail business.

The business has generated strong returns on capital over time, mainly due to the less capital-intensive nature of its operations, particularly compared to the Upstream business (as we can see in the chart below). For instance, capex/sales within Upstream has ranged between 20-40% over the last decade, versus just 1-2% for the Downstream business.

Segment ROACE	2015	2016	2017	2018	2019
Upstream	6.4%	4.8%	11.2%	21.1%	15.5%
Downstream	15.6%	11.1%	14.2%	15.1%	12.9%
Capex/sales					
Upstream	42%	48%	30%	21%	23%
Downstream	1%	1%	1%	1%	1%

Source: company filings (annual report) – ROACE defined as replacement cost profit / (average capital employed excluding cash and goodwill)

Management estimates the Downstream business should earn a 15-20% return on capital employed in the long-term. Much of this will be driven by the move away from more capital-intensive areas such as refining and towards the service station network.

Allied with strong returns, there should be attractive growth opportunities for the Downstream business. Firstly, BP is aiming to increase the proportion of service station revenues that come from convenience as opposed to solely fuel sales, via partnerships with dedicated food and drink retailers such Marks and Spencer and Wild Bean Café. This would be incremental to profitability, with management estimating that service stations with a Marks and Spencer minimart attached generate double the gross profit margins of standalone sites. BP are aiming for margin share from convenience and electrification revenues (see below) to rise from 25% to 50% out to 2030. In terms of expanding the current network, BP is increasingly focused on growth markets, particularly in underpenetrated developing markets, and is therefore aiming for 8,000 new sites across China, India, Indonesia and Mexico (from a current base of 1,300). Convenience sites in developing markets are expected to increase to 3,000 by 2030, from their current 1,600 base. The success of the business is not contingent on growing the network, however. For instance, the number of service stations in the UK has been steadily falling over time (dropping by 35% from 2000-2020) yet BP have managed to mitigate this decline by increasing margin share from convenience revenues.[10]

In addition, the service station network should be highly adaptable to a low carbon world. BP expects that global demand for road transport fuel will remain flat-out to 2030, and therefore are aiming to install additional EV charging points at retail sites, with plans to expand the current EV charging base of 7,500 by 10-fold to 75,000 by 2030.[11] The scale of this endeavour should not be underestimated as electric vehicle charging needs to accelerate and the gas service station model reimagined. If fewer service stations are required over time, as battery storage increases, there is a value to the real estate. The sites can become convenience stores with great accessibility or redeveloped as prime real estate on principal transport routes. Living on a motorway could be far more appealing in an electric world!

10 Source: company filings (annual report + BP Capital Markets Day 2020).

11 Source: BP Energy Outlook (https://www.bp.com/content/dam/bp/business-sites/en/global/corporate/pdfs/energy-economics/energy-outlook/bp-energy-outlook-2020.pdf).

Alignment

From an alignment perspective, there are some encouraging signs that under the leadership of new CEO, Bernard Looney. BP is moving away from its prior focus on volumes, and adopting a more value-driven mindset around returns on capital and cash flow. As recently as 2014, management bonuses were based on growth in major projects (defined as requiring investment of at least $250m) and operating profit, with no appropriate metric included to reflect the high capital intensity of the business, particularly within the Upstream operation. It is therefore a positive to see that management incentives now include return on capital employed and free cash flow, which should increase the chances of capital being allocated towards more profitable, cash generative projects rather than those with the highest production profile (particularly within the Upstream business). Taking on the role of CEO in February 2020, Looney has entered the business at a difficult time, however his attitude is so far encouraging. Management claims it is no longer looking to anticipate movements in the commodity price, but rather allocate capital with a through the cycle view, whilst focusing on those elements that are within its control, namely capital expenditure and operating expense levels.

The shadow of the 2010 Gulf of Mexico oil spill will likely still loom large in the eyes of many. BP continues to pay fines related to the spill, albeit their magnitude has been steadily falling to a reasonably small amount as a percentage of operating cash flow. It appears the company has learnt some hard lessons from the experience, which revealed systematic failures in BP's risk management approach and safety culture more broadly, with management now claiming the firm's priority is operational safety. Talk can be cheap, therefore it is encouraging to see concrete signs of improvements in recent years, with recordable injuries frequency, days away from work frequency and number of oil spills all falling over the last five years, as we can see in the table below.

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Day away from work frequeny	0.19	0.09	0.08	0.07	0.08	0.08	0.05	0.06	0.05	0.05
Recordable injuries frequency	0.61	0.36	0.35	0.31	0.31	0.24	0.21	0.22	0.20	0.17
Oil spills no.	n/d	n/d	n/d	n/d	156	146	149	139	124	152

Source: company filings (annual report)

In addition, there is a 20% weighting towards safety contained within management's annual bonus scorecard, while key investment criteria for projects has recently been amended to include assessment of safety alongside other factors such as economic returns and certainty of cash flows.[12] While the oil and gas industry will likely continue to be at higher risk from a health and safety perspective given the inherent risk in the sector, both the magnitude of risk (as the mix of the business changes) and the management appear to be heading in the right direction.

12 Source: company filings (annual report).

Valuation

As mentioned, the energy sector has been unloved by investors in recent years, and BP has been no exception to this rule. The shares have steadily halved over the last decade, with recent Covid-driven struggles pushing the share price down to a 25-year low in 2020.

However, there is the potential for the free cash flow generation of the business to materially improve over time, which the current share price fails to reflect. Management's increased focus on profitability versus volumes means only the highest returning Upstream projects should receive investment, while management has reacted to recent commodity price weakness to drive meaningful reductions in operating costs per barrel. Assuming an average oil price of $42, the Upstream business is likely to generate c.$36bn in revenues. In response to Covid-19, management has identified $2.5bn of operating expense reductions which should reduce cash cost per barrel from $16 in 2019 to c.$13. Keeping the depreciation, depletion and amortisation charge and dividend per barrel flat, whilst also assuming lower Macondo payments of $600m implies a total cost per barrel of c.$38. As noted above, management has indicated Upstream capex will be c.$9bn going forward, which would result in pre-tax free cash flow of c.$17bn.

Given the lack of impending competitor supply additions within the Downstream space, if revenues revert to similar levels as in 2019, of c.$250bn and assuming a 2% operating margin (the average of the past five years) would result in c.$4.6bn of operating profit. Capex is set to fall from $2bn to $1bn as the investment is increasingly allocated away from asset intensive refining towards the capital light fuels retail business, which would result in pre-tax free cash flow of c.$5bn.

Shareholders now have a greater degree of visibility into the returns on capital BP's renewables business should generate at scale. If BP can indeed generate a 9% return on capital on the $3-4bn of capital investment it intends to deploy in the business by 2025, this would result in cumulative free cash flow of c.$800m.

BP retains a 19.75% position in the Russian oil and gas producer Rosneft. Rosneft has paid a consistent and growing dividend, which is arguably the main tangible value that BP shareholders are likely to receive from their Russian asset, given it is unclear how BP can unilaterally exit its stake. BP has received just over $500m in dividends on average p.a. over the past 5 years. Discounting this figure back at 8% - given we are only valuing the dividends rather than the entire Rosneft FCF, which would warrant a higher rate to reflect the risk of leakage and value destruction – results in a value of c.$6.3bn.[13]

Bringing these elements together results in pre-tax free cash flow of just under $23bn. Capitalising these cash flows at an 10x EV/FCF multiple results in an EV of $141bn. When adjusted for Macondo payments of $600m, the Rosneft stake, planned asset disposals of $15bn and net debt and pension liability, this results in a market cap of $119bn and an intrinsic value of $5.90 or £4.60 per share – implying significant upside to the current share price of £2.77.

Taking a more pessimistic outlook: BP has taken steps to build a more resilient business that should be less susceptible to the inevitable downturns of the commodity price cycle. Firstly, management has identified a further $1bn of cash cost reductions within the Upstream and $1-2bn of additional capex reductions, mainly through idling higher cost sites. As a result of these steps, even in an extreme scenario where Brent drops to $25, the Upstream business would still generate pre-tax free cash flow of c.$4.8bn.

13 As a sense check, the current market value of BP's stake in Rosneft is $10.2bn. Applying a 25% holding company discount to this would result in a value of c.$7.6bn, making this valuation appear reasonably conservative.

In terms of the Downstream business there is some flexibility to operating expense and capex from slowing expansion of the retail fuel network. Assuming revenues drop by 40% from Fy19 levels as demand dries up due to broader economic weakness, and then applying trough margin of 0.5% (from 2009) would result in pre-tax free cash flow of $1.3bn. Taken together, this still results in a 5% FCF to EV yield, which seems an attractive outcome were we to enter a far lower commodity price environment.

In addition, the retail fuel network provides an asset backing element to the valuation. BP fully owns 25% of its retail network (with the remainder a mixture of leases and franchises). If we look to recent acquisitions in the space as a proxy for the market value of these assets, Motor Fuel Group bought MRH – which operated 900 petrol stations and convenience retail sites across the UK – for £1.2bn in 2018, implying a value of $1.7m per station.[14] Applying a similar value per station to BP's network would result in an $8bn valuation for these assets.

BP has a clear pathway to reverse the industry's poor track record of value creation for shareholders through its strategic pivot, by shifting its focus from production volumes to project value and taking a through the cycle approach to capital allocation. It is also trailblazing among the supermajors on how to adapt their model to a less fossil-intensive, cleaner environment, and is key in developing the commercial case for renewable investment.

As investors, is it time for us to give BP the capital to be part of the environmental solution rather than part of the problem?

14 Source: https://www.motorfuelgroup.com/mfg-acquires-mrh/

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As at 10th February 2021

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