# CLIMATE CHALLENGES

## SHAREHOLDER ENGAGEMENT AS A VEHICLE FOR CHANGE

# *MAJOR* CHALLENGE

Climate change is a significant challenge for companies, investors and society as a whole. The latest IPCC report outlines the major impacts being felt from a 1.5°C increase in global warming. If profound disruptions are to result from this improbable scenario, which assumes that the increase in greenhouse gas emissions will stop by this year, one can only imagine the devastating effects of **worst-case scenarios.**

The impact of global warming is already tangible on a global scale – a rise in heat waves and forest fires; increased or insufficient precipitation; decreased biodiversity; higher ocean levels; and impacts on agricultural production. The reality illustrates how we are gradually moving from climate risk management to climate crisis management.

Companies face a number of risks in this climate crisis context: **physical risks** (the effect of above-mentioned impacts on infrastructure) and **transition risks** (carbon regulation, technological advances and changing energy costs). The fossil fuel-based business models of some companies are being questioned in the context of a low-carbon economy. The production of long-term value for these companies is under threat, posing a risk to investors.

Things are changing, however, for companies as well as investors, and even for governments. Responsible investment (RI) practices are making progress and it is increasingly common for investors to consider environmental factors. The pressure from investors has intensified when it comes to climate issues. The number of climate-related shareholder resolutions is constantly expanding, and their mobilization in connection with impactful collaboration initiatives, such as the Climate Action 100+, bolstered by growing support from the largest asset managers[1], all attest to this.

Even if a few countries (particularly Australia and the U.S.) continue to develop policies that go against this movement, many other governments have been acting, especially through groups of experts (primarily in Canada, Europe, the U.K. and China), whose mandates are aimed at developing concrete proposals leading to increased funding for mitigation and adaptation strategies to deal with these risks. Technologies are advancing and the cost of renewable energy is decreasing. Lastly, standards are progressively taking shape for climate risk management disclosure, geared to companies and investors, following the work that was accomplished by the Task Force on Climate-related Financial Disclosures (TCFD).

Nonetheless, this energy transition is not happening fast enough and remains a major issue. As the IPCC states, «Limiting global warming to 1.5°C would require rapid, far-reaching and unprecedented changes in all aspects of society.» **We need to reduce our emissions by 45% compared with 2010 levels, and do so by 2030 if we are to achieve carbon neutrality by 2050, according to their 2019 report**.

1 Such as Black Rock, which recently joined the Climate Action 100+.

With regard to this challenge, investors are being led to manage climate risks better and contribute to energy transition. To ensure this, various RI strategies are being offered to them: negative screening or exclusion (divestiture); positive screens (selection of companies based on their excellent performance in their sector); investment in specific themes (clean technologies, etc.); integration of ESG factors in traditional financial analysis; investment that is specifically impact-oriented; and shareholder engagement (through voting rights and dialogue with companies).

While movements that promote divestiture have spread in recent years, **we at Æquo favour constructive dialogue with companies as a vehicle for impact and change** in order to guide companies to contribute to an economy aligned with Paris Agreement targets (to maintain global warming below 2 degrees and, ideally, 1.5 degrees).

# *COMPLEX AND* **NUANCED ISSUES**

Divestiture is part of an IR strategy. It is an investor's last resort when dealing with resistant emitters, to force the latter to take into account the risks facing them. For some investors with specific missions, it is clear that certain industries need to be avoided. For example, it would be difficult for an environmental protection foundation to present itself as defending nature while leveraging future fossil fuel expansion. Similarly, investing in the tobacco industry runs counter to the values held by beneficiaries of a healthcare professional pension fund. However, **in most cases, we do not support large-scale divestiture for companies associated with fossil fuels**. From our perspective as an active investor, divestiture should only be considered as a last resort. Here are the four main arguments underlying our approach.

To begin with, climate change represents a **systemic risk** for which **institutional investors, who are by definition long-term investors**, must prepare themselves. If the objective is to limit this risk, it is difficult to identify and cover all companies in question—this goes well beyond a single sector (or subsector) within energy production. Moreover, for the average investor, large-scale divestiture from a sector runs the risk of creating an imbalance in the asset mix, while increasing the risk profile. This is especially the case in the Canadian market, where a significant number of energy companies are associated with fossil fuels. In addition, divesting from one sector means reinvesting in others, such as banks, which continue to invest in (or lend to) that same sector. As such, it is necessary to discuss this systemic risk in a comprehensive fashion, without focusing solely on a specific group of companies, which is difficult to identify. **What should be encouraged is change from a wide range of companies, particularly with regard to the reduction of direct and indirect emissions.**

Secondly, **the divestiture card can be played only once**. When no longer a shareholder, the investor has no hope of being able to influence the company's practices. Furthermore, the resold shares will immediately be repurchased by other investors, who may not practice ESG shareholder engagement.

Our third argument is that ESG issues are usually not fragmented, but rather overlap. Take the example of a «just transition,» which represents the need to integrate social concerns, such as the retraining of workers, into managing the environmental risks related to energy transition. **It is crucial to discuss the issues in as broad a forum as possible, taking into consideration all dimensions of a problem,** to avoid solutions that exacerbate the problem or which create new ones.

Finally, when carried out in an active, thorough, and impact-oriented manner, the dialogue with companies **helps limit the risks to the investor while it guides companies to become more sustainable**.

# *SHAREHOLDER DIALOGUE* AS A VEHICLE FOR IMPACT

## WHY ENGAGEMENT

**1** The impact of climate change is global and **divesting from one sector does not eliminate this risk.** Furthermore, for Canadian investors, this **entails other risks** (concentration, exposure to exchange rate fluctuations, etc.).

**2** Beyond sending a strong message, the divestiture card can only be played once. **A player loses the power to influence** if one is no longer even a potential investor.

**3** With shareholder engagement, **dialogue ensures our participation in a company's governance** and helps us advance best practices across a wide range of topics, e.g., infrastructure safety, human rights (including the rights of indigenous peoples), transition financing, etc.

**4** Shareholder engagement is the **vehicle for a change in corporate practices**.

At Æquo, we are convinced that companies are part of the solution and that investors play an important role in advancing best corporate practices and adapting their business models to climate constraints. Our mission is to see us collectively find solutions to this century's most pressing issues, in collaboration with the companies held by our clients, while ensuring they meet their fiduciary duty.

Whether they relate to the companies in our action plans or to other companies targeted through collaborative initiatives, there are various examples to illustrate the impact of dialogue and, more generally, shareholder engagement[2].

So, even if it is more often collective impact made possible thanks to joint pressure from various stakeholders, we have taken part in encouraging a number of companies toward better climate risk management. This progress is reflected in better climate risk analysis and disclosure, decreased GHG emissions, and even investment in transition, among other things. **Shareholder engagement helps companies implement changes which, if not put in place now, will be imposed on them tomorrow.**

Beyond the impact on companies' ESG practices, engagement (in the form of dialogue) **brings multiple benefits, for both the company and the investor,** as proven in a study commissioned by the PRI.

Firstly, it promotes an exchange of information. This allows investors to better evaluate and communicate their expectations to companies. The companies can then provide details about their practices and their business context.

Next, the engagement process makes it possible for these two players to develop their knowledge about managing ESG issues and new trends; for example, the development of carbon footprint calculation methods or even climate scenario analysis.

Lastly, engagement has a political impact by facilitating the development of internal and external relationships for companies and investors, who thereby contribute to the advancement of an ESG program within their organizations.

Still, in order for the shareholder engagement to succeed and become a vehicle for impact, it must be led as efficiently as possible.

2 For example, see our annual reports or the Climate Action 100+ Progress Report.

# *AN OPEN AND SYSTEMATIC* ENGAGEMENT APPROACH

By favouring an approach aimed at better managing risks, we address companies' material ESG issues, including the climate issue. **The «material» issues are those that contribute to the creation of long-term value** for the company, its investors and other stakeholders.

The quality of the relationships with companies is at the heart of a successful dialogue. **These dialogues are a work in progress** and are usually held over several months, through multiple discussions. In fact, it is important to build mutual trust with companies, as ESG practices do not change overnight.

Shareholder engagement must also be founded on objective and robust methods. To begin, we choose companies on the basis of their ESG performance/risks, assessed according to **poor ESG performance and/or controversies** compared with their sector average.

Once the companies have been chosen, **we thoroughly analyze their ESG policies and practices** (according to the company's disclosures, industry best practices, independent ESG reports, news coverage, etc.), and then we draft individual action plans.

For each dialogue we lead, **measurable objectives need to be defined** and presented to companies as recommendations, which are then monitored. With regard to climate issues, our objectives are in line with the recommendations of international experts (those of the TCFD). Our aim is to get companies to demonstrate that they have adapted their climate risk business strategies and practices. In addition to disclosure, we ask them to put in place the appropriate governance to properly manage this issue, especially with regard to board competencies, responsibility and oversight; compensation tied to climate performance; disclosure of risk management and the strategy to that effect (transition plan, scenario analysis, proportion of investments in renewable energy); and definition of objectives, in the form of emission reduction targets.

Occasionally, a dialogue does not achieve the level of progress we had been seeking. In such cases, our first step is to write a letter to the company's Board of Directors or its Chair, outlining the situation and our demands. If this step does not yield the desired results, we consider submitting a **shareholder proposal**. In some strategic cases, and in full transparency with the company, a shareholder proposal might also be submitted if it will help speed up the adoption of certain practices.

**We always try to have a discussion with the people responsible for managing the issues discussed** (in this case climate risk). Generally speaking, they are the ones who are proficient in their topic and have the power within the organization to move better practices forward.

It is also critical for shareholder dialogue practices to be **aligned with voting policies**. This alignment allows the engagement strategy to be complete, efficient, and flexible. The consistency between these two strategies underpinning shareholder engagement increases the impact by turning up the pressure on companies in a single, coherent strategy. This complete approach also allows for flexibility. For example, in connection with the dialogue held, it would be possible to vote against the nomination of the Board Chair if it were deemed that the company was not advancing quickly enough in its consideration of climate risk.

Lastly, it is important to **report on the methods and practices** of shareholder engagement put in place, as well as their impact. This disclosure is central to the objective of improving responsible investment practices and corporate responsibility. In the same way that it is necessary to disclose votes, it is important to disclose the content (issues discussed and targets set) and progress of dialogues.

**Jean-Philippe Renaut**
*Chief Executive Officer*

**Arnaud Celka**
*Head of Research*

## A SYSTEMATIC ENGAGEMENT PROCESS ORIENTED TOWARD CHANGE

1. **ESG analysis** of companies and development of engagement plans that are **consistent with voting policies**
2. Development of **objectives** and **monitoring of progress**
3. Discussions with the **relevant people** within the company (those who have proficiency in the topics and the organizational power to move practices forward)
4. Documentation and **disclosure of methods and practices** of engagement as well as their **impact**

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Shareholder Engagement
Services

aequo.ca

info@aequo.ca

1111 rue Saint-Urbain, bureau 211, Montreal, Quebec H2Z 1Y6