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GENERATION IM GLOBAL EQUITY QUARTERLY INVESTOR LETTER

July 2021

DEAR FELLOW INVESTOR

We have seen something of an outbreak of multilateral cooperation this quarter, across a number of areas we care deeply about. We want to give you an idea of how these developments intersect with our investment ideas.

To take a few examples, we have a first-of-its-kind agreement on taxation from the G7, alongside commitments on climate-related disclosure and ending coal investment, a G20 agreement on special drawing rights at the International Monetary Fund and the 'Leaders Summit on Climate', which added fresh momentum in the run-up to COP26.

None of these deals and discussions delivered precisely what we hoped, and big gaps remain. Yet, taking a step back, we see that the major economies are finding ways to collaborate and are often exceeding expectations. This feels new and important.

So, what explains this sudden wave of commitments? Not an outbreak of global optimism. Political climates in many countries still trend towards nationalism, and tensions between the US and China, in particular, appear to be getting worse. Instead, we suspect that politicians fear the public's wrath – over their perceived inaction on tax avoidance by certain corporations, and on the climate crisis. They also want to avoid further lockdowns and know that COVID-19 can only be brought under long-term control through deeper cooperation.

Geopolitical forces are at work, too. The United States is on a diplomatic surge, designed to re-establish its reputation for international leadership and to demonstrate how, by working with its allies, it can still set the rules of the road. One of this effort's most impressive successes has been on ending overseas coal finance. First South Korea and then Japan made commitments, enabling a G7 deal and leaving China as the last remaining major coal financier not to make such a pledge.[1]

"We commit now to an end to new direct government support for unabated international thermal coal power generation by the end of 2021."
G7 communiqué

[1] See article in Washington Post on G7 commitment on international coal financing.

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The G7 projected a vision of democratic countries banding together to counter China. But beneath the surface there is evidence of a more pragmatic approach on climate. Separate China-US and China-EU climate summits this quarter helped to build confidence and coordinate on key points. The US and China agreed to join the Kigali Amendment to the Montreal Protocol, which commits companies to phasing down hydrofluorocarbons. A key outcome of the G7 summit, the commitment to mandatory climate-related disclosure, was carefully coordinated with China's own move in this direction.

In short, what we are seeing is international collaboration as a response to political realities, rather than progressive ideals alone. We might well look back on this quarter as the moment when climate became a geopolitical priority for all the major economies. We should, however, keep a close eye on implementation, which will be politically fraught in many places – not least on taxation and decarbonisation.

We are mindful that a significant ramping-up of ambition is still required to avert disaster. At the end of 2020, the 'emissions gap' between government plans and a 1.5 degrees Celsius pathway was projected to be about 23 to 27 GtCO2e in 2030. In April, we had a new round of government commitments at the Leaders Summit on Climate. Yet these only closed the gap by 2.6 to 3.9 gigatonnes of equivalent carbon dioxide (GtCO2e), or 10% to 15% of what is needed. The G7 also failed to make a significant step forward on climate finance for poor countries. There is much work to do before COP26.

The vaccine roll-out is a top priority. With many poor countries experiencing a humanitarian disaster, the lack of vaccine access in the developing world is urgent on its own terms. It also poses a potentially fatal threat to success at COP26, since poorer countries can hardly be expected to take richer countries' promises seriously against this backdrop. On taxation, watch this space. We will return to the topic in more detail in an Insights piece in the coming months.

INVESTOR ACTION ON CLIMATE

It will not have escaped your notice that this was a big quarter for investor engagement on climate change. Activist investor Engine No. 1 succeeded in getting three of its nominees onto the board of ExxonMobil. To say that Exxon has been dragging its feet on the transition to a low-carbon economy would be an understatement. This is a watershed moment for investor activism, more of which will surely follow.

In parallel, investors engaged this quarter in fraught discussions over Shell's climate action plan. On the one hand, a net zero benchmarking exercise highlighted significant gaps in the plan. The company has an intensity-based commitment (the average amount of greenhouse gas emissions which are produced for each unit of energy sold), rather than an absolute target to cut oil and gas production. On the other hand, many investors felt that the company's relatively constructive engagement on climate should be rewarded. In the end, the company's plan received 88% support. Another resolution put forward by an activist group asked Shell to set 'inspirational' targets on greenhouse gas emissions. This received 33% support, up from just 14% the year before – a sign of investors' appetite for further action.[2]

The dust had barely settled on this episode when a Dutch court ordered Shell to cut its emissions faster, finding that the company is violating human rights by contributing to climate change. The decision requires Shell to cut emissions by 45% by 2030 (on an absolute basis and including 'Scope 3' emissions, although there is some flexibility on the latter). This is the first time a national court has compelled a private company to cut emissions in line with the Paris Agreement.[3] Shell is expected to appeal, but whatever the final outcome of the case, this judgement will be looked at closely by litigators around the world. Shell's CEO, Ben van Beurden, says that the ruling will accelerate the company's transition strategy.[4]

[2] See article in Reuters on the Shell transition plan.
[3] See website of Herbert Smith Freehills on the Shell court ruling.
[4] Reuters article on Shell CEO's response to the court ruling.

PROXY VOTING

We have reviewed our Proxy Voting Principles to ensure that they continue to guide analysts appropriately in this decisive decade for investor stewardship. Our updated principles make clear that we will hold directors to account when we have serious concerns about the performance of their duties on the board. This includes holding the Chair of the Board responsible for any failure to meet our previously communicated expectations with respect to climate disclosure or action, and holding the Chair of the Nomination Committee responsible for the diversity of the board and, when within their responsibilities, the diversity of the executive committee.

The principles now make clear our expectation that company reports and accounts should be prepared in line with assumptions consistent with the goals of the Paris Agreement; and indicate our support for new shareholder proposals, seen in numbers this year, calling for annual 'say on climate' votes and racial equity audits. Finally, we have tightened our expectations on important corporate governance issues, including the retendering of audit contracts, auditor rotation and director overboarding. We have set out more detailed guidance for analysts on executive compensation, including on the need for executive compensation to sit well with the compensation arrangements in the firm as a whole.

We have published the updated principles on our website here.

A LANDMARK IEA REPORT

"There is no need for investment in new fossil fuel supply in our net zero pathway."
International Energy Agency

An accelerant to climate action came from the unlikeliest of places in March. The International Energy Agency (IEA) – founded in 1974 in the wake of the first oil crisis, with a mandate to protect oil-importing countries – released a full analysis on meeting the 1.5 degrees goal for the first time.[5]

In some ways, its conclusions are not new. The IEA says that meeting the goal is possible, but the road is narrow and action must be taken now. The changes required in particular sectors are dramatic, but no more so than other organisations have found.

But this is not just any report. The IEA is used by companies and other stakeholders as a source of reference material for evaluating investment decisions. When oil companies say that they are simply moving at pace with the rest of the world, for instance, they point to IEA scenarios to support this conclusion. There has also been growing frustration with the IEA over its expectations for renewable energy deployment, which it has consistently underestimated.

Like all energy experts, the IEA says that its scenarios are just that – they are not predictions. But its unique position means that these scenarios help shape future capital allocation decisions. You could say that the IEA helps make the weather – and the climate, too.

The most striking conclusion of the report bears repeating: 'There is no need for investment in new fossil fuel supply in our net zero pathway.' No company or government can now approve new fossil fuel projects while still arguing that they are committed to 1.5 degrees. Or rather, they will come under intense scrutiny when they try to do so. Given the binary nature of the IEA's conclusion, we believe a fierce pushback from fossil fuel-intensive sectors and economies is inevitable.

The report also had an important message for advanced economies and the companies operating within them – they need to reach net zero CO2 emissions, not by 2050, but by around 2045.

[5] IEA (2021) Net Zero by 2050 – a Roadmap for the Global Energy Sector. All Rights Reserved. Report is available here. This is the first, full 1.5-degree scenario exercise from the IEA. An earlier 2019 outline analysis by the IEA looked only until 2030 and was not fully consistent with 1.5 degrees. For instance, see https://www.climatechangenews.com/2019/11/13/iea-world-energy-outlook-outlines-1-5c-scenario/.

Finally, the report contains a crystal-clear graphic showing what is needed to meet the 1.5 degrees goal, which we have appended to this letter for your interest. We have indicated on the diagram where proposed sector-wide changes have particular implications for Focus List companies. There is clearly a huge opportunity, but we are conscious that all companies and investments will be impaired if climate action remains too slow.

THE TIME VALUE OF CARBON

You may have noticed that we shared our latest Insights piece with you in June, on the subject of the Time Value of Carbon (TVC). You can find it here on our website.

Its central argument is that prompt climate action is undervalued. There is a growing understanding that we must cut CO2 emissions in half by 2030 at the global level, while making deep cuts in methane and other greenhouse gases. The focus of the piece is on why these dynamics are highly relevant for individual companies – and, therefore, for investors.

We point to several ways that we believe climate action today is worth more than action tomorrow. First, companies that fail to act now on emissions will not be able to catch up, due to the escalating nature of the challenge. Second, we expect governments to use more interventionist policies, reducing the chances of a smooth and orderly transition. Third, there is the risk of heading in the wrong direction. At some point soon, companies that are not fit for a net zero world will see value quickly shift to those that are.

It is worth noting how this connects to our thinking on net zero investing, which was the subject of our previous Insights piece (available here on our website). When there is no clarity on a company's net zero goal, investors should certainly treat any bold target with scepticism. But there is a flip side: when companies do have a credible plan and are implementing it today, with cuts as fast or faster than the science demands, we believe this has meaningful value.

Even when the precise path to net zero is unclear for a company, pioneering executive teams are creating options that may bear fruit in later phases of decarbonisation, or even beyond this, in a future net zero society. We should value this today too.

The piece is a starting point rather than a roadmap. That said, we are looking closely at how we can incorporate TVC into our investment practice as a next step. Several organisations have already reached out to discuss the concept. We would welcome the opportunity to discuss it with you too.

ASHTEAD GROUP

Ashtead is an equipment rental company with national networks in the US and the UK, and a growing position in Canada. Its largest customer is the construction sector, to which it provides equipment such as aerial work platforms, forklift trucks and diggers. However, slightly over half of its sales are to non-construction companies, to which it provides a range of general tools and other equipment, such as portable power supplies, pumps and scaffolding.

Why would customers want to rent rather than own equipment? Financially, the key is utilisation. Unless you are using a piece of equipment more than half the time, you are usually better off renting. Average utilisation rates are only 25% to 30%, so there are many companies that can benefit from renting.[6] Also, for companies that cannot afford to purchase equipment themselves, rental is the answer.

There are operational advantages too. Renting usually means newer and well-maintained equipment, plus access to mechanics if issues arise. You also do not need to work out in advance which equipment will be needed where, or when, or how to ship it around. It is a very flexible model, providing ready access to exactly the right equipment, including for niche tasks.

[6] Internal estimates based on Generation internal analysis and conversations with experts.

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This flexibility is valuable because the penalties for construction delays, and the bonuses for on-time delivery, are often meaningful. Consequently, construction companies will often rent equipment even when their high utilisation rates suggest they might be better off owning it.

Ashtead has performed impressively, with a 15% revenue compound annual growth rate (CAGR) over the last 15 years, of which around 70% has been organic growth and 30% has come through acquisitions. The overall equipment rental market in the United States has grown nicely over the period, but nothing like as fast. The company's market share has therefore doubled from 5% to 10% since 2013. This still leaves a potentially long runway for growth, and we expect the lengthy, fragmented tail of smaller rental companies will struggle to compete with large players like Ashtead.

The sustainability case for equipment rental lies in the use of materials and energy. The sharing of equipment by multiple customers means higher utilisation rates, and ultimately less equipment manufactured. Logistics are also more efficient. Ashtead's networks mean that equipment is often available close to the end customer – the average distance is 25 miles. Companies that own equipment and operate at multiple sites typically have to transport this heavy equipment over much longer distances – 150 miles at a conservative estimate.[7]

Possibly most impactful, though, is the potential to transition from a primarily diesel-operated fleet to more sustainable machines, most likely run on electricity and hydrogen. It is striking that equipment rental penetration saw explosive growth in the last 'sustainability cycle', with the transition from Tier 0 to Tier 4 engines between 1996 and 2004 (higher tiers indicate a more robust emissions standard). We have ongoing discussions with the company on this opportunity, and also on the potential for a more data-driven approach to monitoring equipment usage.

We hope you enjoy the *Sustainability Trends Report 2021*, our annual assessment of the landscape of sustainability trends from a business and investment perspective. The report will be launched on 14th July and you will be able to find it via the Generation homepage. If you haven't done so already, you can sign up for the launch event here. This is the fifth year we have put this report together and, as always, we hope it sparks debates and discussion with all our clients.

Thank you for the support and trust you have placed in us.

Regards,

Miguel Nogales and Mark Ferguson, co-CIOs

[7] Internal estimates based on Generation internal analysis and conversations with experts.

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PORTFOLIO METRICS

Below are select Environmental, Social and Governance (ESG) metrics alongside financial metrics for the portfolio.[8]

	FACTOR	PORTFOLIO	BENCHMARK
E	Carbon footprint - (tonnes) CO_2equivalent/$m (revs)[9]	58	251
	Greenhouse gas - imputed cost (% of revenues)[9]	0.5%	1.4%
	Water & resource use - imputed cost (% of revenues)[9]	0.7%	1.5%
	Waste & pollution - imputed cost (% of revenues)[9]	0.4%	0.9%
	Percentage of companies that report GHG emissions[9]	74%	75%
	Percentage of companies in SBT initiative[10]	32%	23%
S	Human capital development score[11]	5.7	5.2
	Data security score[11]	5.8	5.2
	% of employees would recommend company to friend[12]	77%	73%
G	Firm tenure of executive team[13]	12.7 years	N/A
	Fewer than 10% shareholder votes against executive pay[11]	60%	77%
	Equal shareholder voting rights[11]	91%	88%
	CEO total pay less than 3x of median executive officer[11]	69%	75%
	Percentage of shares owned by executives[14]	0.17%	0.10%
	Female board directors[11]	29%	28%
	Board not entrenched[11]	69%	82%
	All non-executive board members on less than four boards[11]	47%	56%
	Independent compensation committee[11]	84%	70%
	Independent board[11]	77%	72%
	Independent chair or lead non-executive director[11]	80%	66%
F	Three-year revenue growth (annualised)[14]	10%	8%
	Gross margin[14]	52%	49%
	Cash flow return on invested capital (CFROI)[15]	13%	6%

Data in green: relative performance above benchmark. Data in red: relative performance below benchmark.

[8] As at 14 June 2021. Portfolio referenced is the Generation IM Global Equity Fund and may not be representative of all client portfolios within the strategy. Referenced data may not be available across all portfolio companies and it is limited to the data received from the source provider. This information may no longer be current. To the extent not sourced from Generation, it is from sources believed reliable. However, Generation does not represent that it is accurate or complete and it should not be relied upon. It should not be deemed representative of future characteristics for the portfolio. For definitions of each metric, please refer to the 'Notes to Metrics' at the end of this letter.
[9] Trucost data.
[10] Generation analysis as at June 2021, based on data from the Science Based Targets initiative and MSCI.
[11] MSCI ESG data.
[12] Glassdoor data.
[13] Generation in-house analysis as at June 2021.
[14] CapIQ.
[15] Credit Suisse Holt.

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GLOBAL EQUITY PORTFOLIO

	30 JUNE 2021	31 MARCH 2021
AUM strategy	USD 32.0 billion	USD 29.3 billion
No. of investments	50	48

GLOBAL AND ASIA EQUITY TEAM

During the quarter, we were pleased to welcome Alice Townshend as a Director to our Consumer sector team.

Alice was previously a research director and product head at boutique investment management firm Arisaig Partners, where she specialised in emerging market businesses. She received a BA in Spanish and Portuguese from King's College London.

THE FIRM

As at 30 June 2021, the Generation team is 104 and assets under management total approximately USD 36.0 billion.[16]

In early February we wrote to you about our plans to launch Just Climate, an investment business dedicated to climate-led investing. Just Climate's mission is to identify and invest in high-impact solutions for climate change mitigation, and to catalyse and multiply capital to scale such solutions in order to limit global temperature rise to less than 1.5 degrees. Just Climate seeks to expand what capital markets value by incorporating impact within a traditional risk-return framework. It aims to set a new standard for robust impact measurement grounded in climate science. Just Climate's initial strategy will seek to optimise for timely climate impact at scale, while delivering attractive financial returns by investing in project and company equity in hard-to-abate sectors.[17] The dedicated investment team is based in Generation's offices in London.

We are very pleased to announce that Shaun Kingsbury CBE has joined us as Just Climate's Chief Investment Officer. Shaun shares our mission and brings a record of accomplishment, including as the founding CEO of the UK Green Investment Bank, the world's first ever green bank, a model that has since been replicated many times over globally. Prior to the Green Investment Bank, Shaun was a Partner and Head of Europe at Hudson Clean Energy Partners, where he established the London office, hired the investment team and helped the firm raise its first private equity fund of over GBP 1 billion AUM. He was recognised by the Queen for his services to the UK Green Economy in 2018. We are excited by this development and look forward to updating you further about Just Climate.

[16] In addition, the firm has USD 2.1 billion assets under supervision as part of its Long-term Equity strategy as at 31 March 2021.
[17] Although Just Climate seeks to deliver attractive financial returns, this is an aspiration and there is no guarantee this goal will be achieved.

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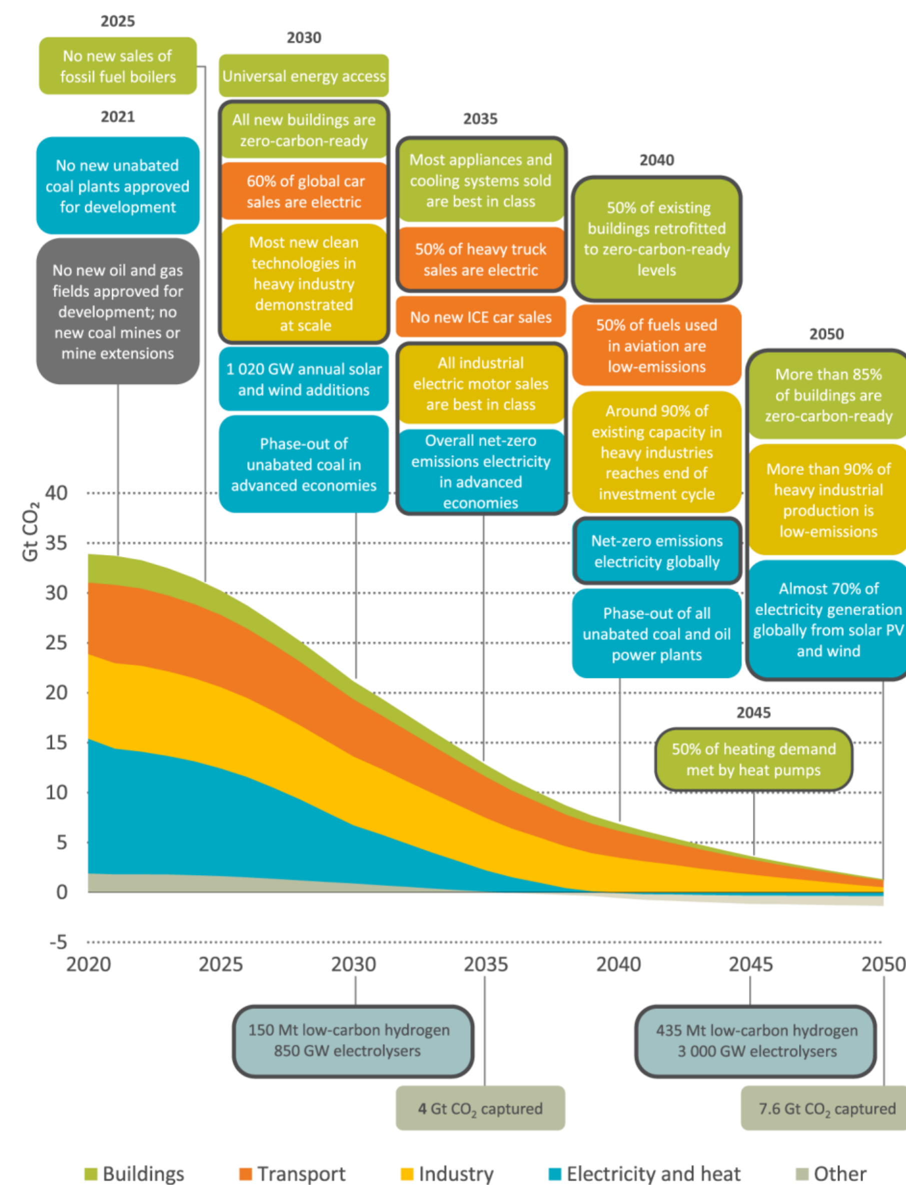
APPENDIX

Our Focus List has meaningful exposure to the growth opportunities identified by the IEA.[18] Notably, many of the IEA measures are not long dated; they imply rapid changes between now and 2030.

The circles highlight the parts which are of particular relevance to our Focus List companies.

The non-circled areas mostly relate to the phasing out of higher carbon technologies. These will benefit companies we cover indirectly. For instance, the phasing out of coal is good for Vestas, the major wind turbine producer, while the phasing out of internal combustion engine (ICE) vehicles and gas boilers will help the many companies in our 'industrials' coverage that focus on electrified mobility and efficient buildings.

Key milestones in the pathway to net zero



[18] IEA (2021) Net Zero by 2050 – a Roadmap for the Global Energy Sector. All Rights Reserved.

IMPORTANT INFORMATION

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If you require more information, please contact Generation Client Service (clientservice@generationim.com or +44 (0)207 537 4700).

FACTOR	METRIC	SUMMARY DESCRIPTION
Average tenure of executives at the firm	Median	Average tenure of the current executives at the company. In our view, longer is considered better.
Fewer than 10% shareholder votes against executive pay	Percentage	Percentage of companies that received less than 10% shareholder votes against executives pay (most recently reported shareholder meeting). Only applies to companies that have 'say on pay' vote.
Equal shareholder voting rights	Percentage	Percentage of companies that have equal voting rights. In our view, a higher number is considered positive.
CEO total pay less than 3x of median executive officer	Percentage	Percentage of companies where the CEO's total pay for the last reported period was no more than 3x the median pay for other named executives. In our view, a higher number is considered better.
Percentage of shares owned by executive & board	Median	Executive share holdings as a percentage of shares outstanding. We show the median for portfolio and benchmark, as the average may be impacted by some companies (often founder run) with large executive ownership stakes.
Female board directors	Average	Percentage of female board directors. In our view, a higher percentage is positive.
Board not entrenched	Percentage	Percentage of companies without an Entrenched Board. The Board Not Entrenchment is inferred only; it is assumed and based on the following criteria from MSCI where board tenure is long and/or there are a significant proportion of older board members. The criteria includes >35% board tenure >15 years, 5 or more directors tenure >15 years, 5 or more directors >70 years old.
All non-executive board members on less than 4 boards	Percentage	Percentage of companies with no overboarded non-executives. The threshold is where a board member serves on four or more public company boards.
Independent compensation committee	Percentage	Percentage of companies with independent compensation committee, where such a committee has been established. Please see below for the independence criteria used.
Independent Board	Average	The Independent Board is inferred only; it is assumed and based on the following criteria from MSCI where it excludes current & prior employees, those employed by predecessor companies, founders, those with family ties or close relationships to an executive, employees of an entity owned by an executive and those who provided services to a senior executive or company within the last 3 years. Non executive compensation must be proportionate with other non executives and less than half of the named executives. Where information is insufficient the director is assumed Non-Independent.
Independent chairman or lead non executive director	Percentage	Percentage of companies which have an independent chair, or where the chair is not independent, an independent lead director. In our view, a higher proportion is considered better. As defined by MSCI, Independence is classified as independent of both management and other interests (employees, Government or major owners).
Human capital development score	Average	MSCI score (0-10) for motivating and engaging employees through variable compensation, work/life balance, training and Employee Share Ownership Programs (ESOPs). MSCI differentiates between labour management and human capital development based on educational attainment, but we aggregate.
Data security score	Average	MSCI score (0-10) for companies attempting to control and protect data through policies, audits, training and other programs.
% of employees would recommend company to friend	Average	Percentage of participating employees who would recommend company to a friend. This metric may warrant caution where a small percentage of the work force report.
Carbon footprint - (tonnes) CO_2equivalent/$m (revs)	Weighted Average	Aggregate tonnes of carbon dioxide (CO_2 equivalent) per $USDm revenue (not restricted to CO_2, includes a basket of emissions).
Green house gas - imputed cost (% of revenues)	Weighted Average	Aggregate green house gas cost (to society) of direct and indirect emissions, based either on disclosed or modelled emissions. Calculated as a percentage of revenues.
Water & resource use - imputed cost (% revenues)	Weighted Average	Aggregate waste and pollution cost, both direct and indirect, either disclosed or modelled. Calculated as a percentage of revenues.
Waste & pollution - imputed cost (% revenues)	Weighted Average	Aggregate water and resource use cost, both direct and indirect, either disclosed or modelled. Calculated as a percentage of revenues.
Percentage of companies that disclose GHG emissions	Percentage	Percentage of companies reporting GHG emissions data including in sustainability reports or via the CDP.
Percentage Companies in Science-based targets initiative (SBTi)	Percentage	Percentage of companies that have joined the Science Based Targets initiative. Please refer to the Science Based Target initiative website for further information.
3yr revenue growth (annualised)	Weighted Average	Aggregate (weighted) three year revenue growth rate to the last reported fiscal year. Revenue growth is not adjusted for acquisitions and disposals.
Gross margin	Weighted Average	Aggregate (weighted) gross margin for the last fiscal year. Gross margin is the difference between revenue and cost of goods sold divided by revenue.
Cash flow return on invested capital (CFROI)	Weighted Average	CFROI (cash flow return on investment) a (trademarked) valuation metric.

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