QUILTER CHEVIOT

RESPONSIBLE INVESTMENT

Capitalising on Climate Opportunity

Across Quilter Cheviot we have identified three thematic engagement priorities. This is part of our climate change theme.

Climate Change is the defining issue of our time and we are at a pivotal moment. From shifting weather patterns that threaten food production, to rising sea levels that increase the risk of catastrophic flooding, the impacts of climate change are global in scope and unprecedented in scale. Without drastic action today, adapting to these impacts in the future will be more difficult and costly.

SDG Alignment

> *"The earth is a fine place and worth fighting for."*
>
> Ernest Hemingway

In Q3 2024 we continued our ongoing thematic engagement program on climate disclosure and transition planning with the largest emitters held within our Climate Assets Funds. The objective is to better understand each company's current plans and progress towards them. Whilst this is the first phase of engagement focused specifically on the holdings in Climate Assets, it is built upon the ongoing thematic engagement that Quilter Cheviot has conducted with the highest emitters amongst its broader investment universe. This previous engagement established a framework of what a robust climate action plan looks like.

1. **A focus on the next ten years with specific short- and medium-term targets (2050 goals are welcome but action over the next decade is critical).**
2. **We want to see a reduction in absolute emissions. This includes Scope 3 metrics and is largely absent of carbon offsets. Carbon intensity measures can be supplemental but should not be the main target.**
3. **Demonstrate alignment of capital expenditure with transition targets – and consideration of Paris Climate goals into significant capital expenditure projects.**
4. **Limited used of carbon offsets. Residual emissions may be abated with offsets and carbon capture and storage, but use should be specific with clear end dates. This should not be a structural element of reduction targets.**

5. **The linking of executive remuneration to internal carbon reduction targets to help integrate transition planning into company strategy.**
6. **Assessment of alignment of climate transition strategy with member industry associations lobbying activities.**
7. **Taking ownership of Scope 3 emissions and building these into carbon reduction targets.**

The Sustainable Investment team favours lower emitting companies but, in some cases, invests in higher emitting companies where considered appropriate. When investing in a higher emitting company, it is particularly important that the company manages its climate risk well; namely having an emission reduction target and a credible plan for reducing its emissions. While the Funds are not managed to defined greenhouse gas (GHG) emission or temperature alignment (e.g. 1.5°C) targets, we consider an assessment of the climate impact of investee companies as fundamental to our analysis. We consider both i) whether a company operates within a high impact sector (including mining, transport, heavy construction & industrial engineering) and ii) positive steps taken by the company to minimise its climate impact. We usually avoid companies from high impact sectors but in certain rare cases we may invest if it had an above average approach to minimising its negative impact (assessed by our independent research provider). Positive steps that we look for include having an independently approved Science Based Target and a detailed, transparent, and credible climate action plan.

Like many investors, the Funds' financed emissions are concentrated in a handful of companies. We engaged with eight of the Funds' highest emitters, who together represent c. 85% of the Funds' Scope 1&2 emissions[1].

Two of the eight, DS Smith and Linde, were covered within the aforementioned engagement activity that focused on Quilter Cheviot's highest emitters.

It is worth highlighting that the companies making up the majority of the Funds' financed emissions have clear sustainability benefits under the SDG themes of People and Planet. In some cases, this is directly related to climate. Railroad operators for example, offer a much more carbon-efficient option for freighting goods, as freight by rail is significantly less carbon emitting than freight by road or air.

Several themes emerged from our discussions

Money where your mouth is

There were encouraging signs that companies were making the necessary capital investment required to decarbonise, putting their 'money where their mouth is' in other words. We had the opportunity to discuss many exciting innovations from companies who are facilitating carbon reductions in both their own operations and those of clients.

A particular highlight was Canadian Pacific Kansas City (CPKC) discussing its focus on developing hydrogen locomotives to decarbonise its fleet, where a high-horsepower hydrogen locomotive has recently successfully completed its first phase of testing. This builds upon the successful trial and introduction of several low-horsepower hydrogen hybrid locomotives over the last couple of years. The potential of this new technology was rather aptly demonstrated last year when a hydrogen locomotive rescued a diesel-powered locomotive frozen on the tracks.

Both Waste Management (WM) and Linde were investing heavily to decarbonise their operations too. Linde is implementing significant capital expenditure over the next five years to retrofit existing facilities with carbon capture technology, supported by the US Inflation Reduction Act. WM continues to invest in its sector-leading renewable natural gas (RNG) fuelling network.

In terms of product development, Aptiv is investing to shift some of its product range to lower-carbon options. It has focused its attention on copper-based products, as this is one of the materials with a larger carbon impact. Aptiv has introduced a carbon-neutral copper wiring harness — using its 'Eco-Core' recycled copper — and included avoided emissions figures to demonstrate the carbon savings of recycled copper products compared to using mined copper.

1 If we include holdings' Scope 3 emissions in the financed emissions, the companies included in this engagement comprise 22% of the total financed emissions of CAF. These figures are based on holdings values as at 30/09/2024 and climate data (from MSCI ESG Manager) as at 16/12/2024.

Working to strengths

Many of the companies we spoke with emphasised the value of experience guiding their decarbonisation programmes. WM pointed to its decades' worth of experience in capturing methane for use as renewable natural gas (RNG). This expertise allows the company to contribute constructively towards industry initiatives aiming to enhance fugitive methane emission capture, such as the Solid Waste Industries for Climate Solutions (SWICS) group's efforts to create more accurate methane emissions models for landfill managers. WM is also leveraging this experience to capitalise on new demand for its RNG to power municipal electricity grids; its extensive RNG network gives the company both market share and influence in this burgeoning field.

SABESP was also able to cite its experience with repurposing byproducts and capitalising on opportunities within its services. The company has previously trialled the use of its sludge byproduct from sewage treatment plants as a biofertiliser for specific contexts (e.g., fuel crops), and now plans to scale this work into a profit-generating product. This presents an opportunity for the company, as well as reducing unnecessary waste from its operations.

Reaping rewards

We recognised a genuine and credible willingness to engage from all companies we spoke with. Of course, some part of this relates to being keen to show they were 'doing the right thing' but we also detected a healthy competitive element too, each company being keen to demonstrate their successes.

Returning to the hydrogen locomotive example, the railroad industry knew it must decarbonise and many of CPKC's peers have been exploring the use of battery-operated locomotives. CPKC had concerns over the recharge time, infrastructure and reliability of battery-based locomotives, and instead explored hydrogen alternatives, establishing its own hydrogen research programme in 2020. Now, they are understandably pleased by what appears to be a sensible divergence from its peers.

We also recognise, it is especially easy for a company to talk about decarbonisation when the decarbonisation strategy aligns well with the company's mandate to generate profit for its shareholders. This is especially true of companies with manual and intensive operations such as WM. The more efficient the operations, the more profitable the company, as well as the less energy required, and the lower its emissions. As an added benefit, the more efficient its capture of natural gas at its landfill sites, the more profit it can generate from its sales. There is no shame in a credible climate action plan that is aligned with the profit motive – it is a *win-win* situation.

Necessary context

We were also reminded of the importance of context. Or more specifically, the complex socio-economic circumstances in which investee companies operate.

Seven of the eight companies have set carbon reduction targets that are externally verified by the Science Based Target Initiative (SBTi). This increases transparency and accountability and is in line with best practice.

The one company that had not was SABESP, the Brazilian water utility company. SABESP passionately and credibly set out the context for why water universalisation is the top priority for the company. They cited examples of a region that SABESP added to coverage in 2020 that has already increased from 2% sewage treatment to 20% this year and is set to reach 50% by next year. Within the socioeconomic context of Brazil, providing access to water and sewage treatment is absolutely life-changing for underserved areas of the community, often within favelas.

Of course, setting climate targets is still important and we are pleased the company has committed to do so next year, but it was a helpful reminder that a company's sustainability strategy must also be tailored and appropriate for what it is specifically trying to achieve. That said, the company clearly recognises the role it can play in reducing its climate impact. Whilst investment decisions are likely to primarily focus on universalisation in the near-term, there is a commitment to do so in ways that would increase efficiency and reduce emissions where opportunities are presented – such as incorporating climate-friendly measures like biomethane capture in sewage treatment centres.

Importance of collaboration

Several of the companies we met with highlighted the value of peer collaboration, particularly in developing innovative solutions. CPKC noted the value of multiple avenues being explored simultaneously by different companies – the more ideas developed and trialled, the sooner a workable solution can emerge. To that end, CPKC has entered a joint venture with rail peer CSX to further develop and deploy hydrogen battery locomotive conversion kits, in an important step towards interoperable low-carbon engines for rail freight companies. Union Pacific emphasised the importance of policy measures promoting cooperation between Class 1 rail carriers, citing the exception under the Association of American Railroads' (AAR) anti-trust conditions allowing members to collaborate on decarbonisation measures.

Incentives promoting cooperation can be formalised government policies (e.g., tax rebate programmes, research grants) and smaller measures, from industry bodies and other entities (e.g., engagement initiatives, grant programmes). WM takes advantage of existing government incentives for the use of its RNG through the US Environmental Protection Agency's Renewable Fuel Standard programme, allowing it to effectively monetise its efforts to decarbonise its rubbish collection fleet.

Drumbeat of regulation

All of our discussions referenced the role of government policies and regulation in promoting decarbonisation work. Forthcoming regulation – particularly the EU's Corporate Sustainability Reporting Directive (CSRD), as well as the disclosure requirements set to apply in California and the new carbon disclosures mandated by the Securities Exchange Commission (SEC) – is top of mind for many companies, as they build capacity and prepare for first disclosures from 2026 onwards.

Sonoco highlighted the importance of regulations like these in encouraging the company to invest in its disclosure and environmental data capacities internally. Just as transparency regimes (such as the Forest Stewardship Council certification) have shifted paper supply companies' supply chains towards recycled material streams, incoming regulations are a key driver in company strategic planning. Sonoco now has a dedicated internal resource for its environmental disclosure obligations and is investing in a supplier data platform in preparation for compliance with these regulations.

As constructive as some regulations can be towards the transition, unstable or inconsistent policy can significantly undermine company strategy. Aptiv pointed to the mixed messaging the car industry has received from different quarters, with the UK rolling back on its previous 2030 electric vehicle (EV) mandate and flagging demand from carmakers for EV components. Consistency in government policy direction is critical to enabling companies to make the longer-term strategic investments facilitating the economic transition, without involving costly shifts in material supplies or sudden market changes.

Outcome

Overall, this thematic engagement was positive and productive. We were able to increase our understanding of the climate action plans of the Fund's top emitters and took the opportunity to provide feedback on best practice along the way. We recognised some impressive work to decarbonise and are generally supportive of plans for further decarbonisation into the future. We do not view this engagement as complete and will continue to engage on this topic - and with these companies - and look forward to the further implementation and, hopefully, results of their plans.

	Approved science-based targets	Emissions disclosed Includes Scope 3	Credible plans for emission reduction in the short to medium term	Credible plans for emission reduction over the longer term	Capital expenditure linked to transition targets	Quality of Sustainability Reporting	Openness and willingness to engage	Articulated Supply Chain Strategy	Cross-industry Collaboration
Union Pacific	🟢	🟢	🟢	🟢	🟢	🟢	🟢	🟢	🟢
Waste Management	🟢	🟢	🟢	🟡	🟢	🟢	🟢	**N/A**	🟢
Aptiv	🟢	🟢	🟡	🟡	🟢	🟡	🟢	🟢	🟡
Canadian Pacific Kansas City	🟢	🟢	🟢	🟢	🟢	🟡	🟢	🟢	🟢
SABESP	🔴	🔴	🟡	🔴	🟢	🟡	🟢	🟡	🟢
Sonoco	🟢	🟡	🟢	🔴	🟡	🟢	🟢	🟡	🟡
DS Smith	🟢	🟢	🔴	🟡	🟡	🟢	🟢	🟢	🟢
Linde	🟢	🟢	🟢	🔴	🟢	🟢	🟢	🔴	🟢

For further information on the Funds' climate impact, please refer to the Task Force on Climate-Related Financial Disclosure (TCFD) reports here.

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