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Resilient carbon transition portfolios: a road map

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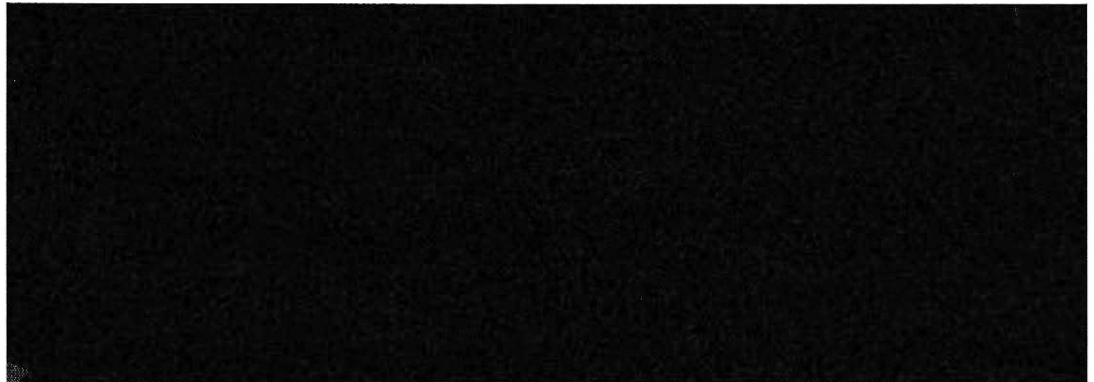

- Transition to a low-carbon global economy may expose investors to significant risks associated with fossil-fuel dependent companies.
- Energy and utilities sectors were most exposed to "asset-stranding" risks. Those standing to benefit were those companies offering low-carbon products and solutions as well as those firms equipped to adapt their business models.
- Identifying leaders and laggards can be used by portfolio managers to mitigate fossil-fuel risks and capitalize on clean-tech opportunities.

Is your portfolio ready for the transition to a low-carbon economy? Which companies, industries and sectors are positioned to benefit? Which ones entail greater risks? The answers are a lot more complicated than alternative energy is in and coal is out.

Companies can be differentiated based on their ability to capitalize (or not) on opportunities in a low-carbon economy. Those distinctions may provide investors with a road map for building resilient carbon-transition portfolios. Companies with the greatest potential to benefit from the growth of low-carbon products and services are the ones positioned as "solutions" and those able to transition from high-risk categories toward solutions.

We classified companies from those likely to have stranded assets to those providing climate-friendly products, using the MSCI Low Carbon Transition assessment framework. In between those two ends of the spectrum are companies that will need to adapt their operations or products, as well as firms that are already well positioned even if they are not selling renewable energy solutions. The full framework is shown in the exhibit below.

MSCI Low Carbon Transition categories and definitions

LOW CARBON

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ASSET STRANDING	Potential to experience "stranding" of physical or natural assets due to regulatory, market and technological forces arising from "low- carbon" transition.
PRODUCT TRANSITION	Reduced demand for carbon-intensive products and services. Winners and losers are defined by the ability to shift product portfolio to low-carbon products.
OPERATIONAL TRANSITION	Increased operational and capital cost due to carbon taxes and investment in carbon emissions mitigation measures leading to lower profitability of companies.
NEUTRAL	Limited exposure to "low-carbon" transition risk. Companies could face physical risk or indirect exposure to transition risk via lending, investment operations.
SOLUTIONS	Potential to benefit through the growth of low-carbon products and services.

At one end of the spectrum, we found that the energy and utilities sectors were most exposed to "asset-stranding" risks — primarily coal companies and coal-fired power generators. Such assets may literally be left in the ground if they are uneconomical to burn, as renewables are increasingly competitive on costs with fossil fuels. As of June 14, 2019, 14% and 9% of companies in the energy and utilities sectors, respectively, faced high risks of asset stranding, according to our assessment.

Utilities, however, showed up at both ends of the spectrum: those offering alternative energy are well positioned as "solutions" providers. Industrials and information technology (IT) play key supporting roles for the low-carbon transition as well. We found that 18% and 11% of these companies, respectively, fell into the solutions category (see exhibit below). Wind turbine manufacturers, for example, are typically industrials companies, while IT players provide products such as software and optimization solutions.

In between solutions and asset stranding are the "product transition" and "operational transition" categories. Oil and gas companies, for instance, face both revenue compression risk from zero-emissions cars and a potential upside from natural gas as an interim power generation decarbonization solution. Other industries, particularly those engaged with commodities industries such as mining and construction materials, may be forced to redesign processes rather than products.

MSCI ACWI IMI companies count by low carbon transition in select sectors

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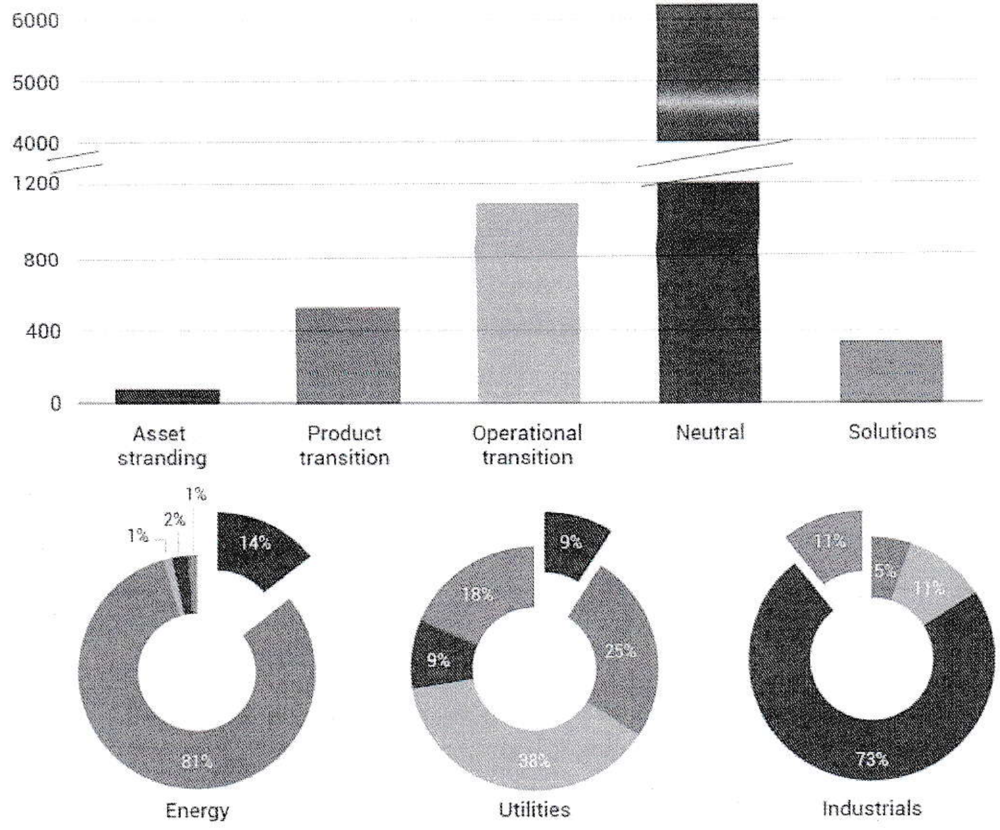

Source: MSCI ESG Research. Data as of June 14, 2019

The transition to a low-carbon economy may result from either regulatory pressure, change in consumer preferences and technological innovation. Being flexible to changing business conditions thus becomes key to future growth. Companies that continue to decrease cost and manage their own exposure to direct and indirect environmental and social impacts across the supply chain are strategically positioned to capture these shifts.

On the flip side, some companies that either can't transition or can't do so quickly enough, like some coal companies, could face the opposite effect. Coal bankruptcies and coal projects cancellations, for example, largely stem from consumer demands for cleaner energy and market forces that reward cleaner and cheaper energy alternatives. There is no debate: The transition to a low-carbon economy is happening. Investors who identify companies that are capable of adjusting their business models and developing strong carbon governance structures may get ahead of the curve in the road ahead.

The author thanks Umar Ashfaq for his contributions to this post.

Further Reading

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