New Energy for Bond Investors

Fixed-income investors can potentially profit by identifying companies playing a central—and even supporting—role in today's energy transition.

Across the global economy, from governments to corporations, large-scale efforts are being undertaken to reduce greenhouse gas emissions. These efforts are sparking demand for innovations that increase energy efficiency and unlock access to more sustainable energy sources such as wind, solar and hydrogen. In turn, that demand is fueling growth among the universe of companies providing everything from the raw materials to the technological know-how to make those innovations possible. The result is a fast-moving energy transition that has pivotal importance for the world economy—and for investors.

In the bond market, investors have begun to embrace a targeted approach to sustainable investing known as transition finance. This strategy involves seeking to identify companies from across the economy that are likely to emerge as leaders in the transition to a less carbon-dependent economy, as well as pinpointing the companies that will provide the tools to get there. It also focuses on industries that historically have had high carbon footprints. It's among these industries that transition finance can have the greatest impact.

"It's clear that if we want to be serious about climate change, we need to take an economywide approach," says Brian Funk, head of credit research at MetLife Investment Management (MIM). "If you want to meet the targets of the Paris Agreement, you have to deal with the parts of the economy that pollute and are hard to abate."

Take the steel industry: Steel demand is expected to grow in the coming decades, and it is a crucial input for the energy transition. The wind and tidal turbines that generate renewable energy are made with steel components, and photovoltaic arrays rely on steel to convert solar energy into electricity. However, steel production is highly carbon intensive. Funk notes that roughly 70% of steel is produced using coal-fired blast furnace technology,[1] and steel production represents between 7% and 9% of all carbon emissions caused by human activity.[2]

But not all steel producers are alike. Some are forward-looking and have taken strides toward decarbonizing the production process by investing in production methods utilizing lower-carbon fuel sources such as hydrogen, electrification, and carbon capture and storage. The companies that succeed in reducing emissions are likely to see powerful competitive advantages. Transition finance seeks to identify these leaders, fund their projects and benefit from their success.

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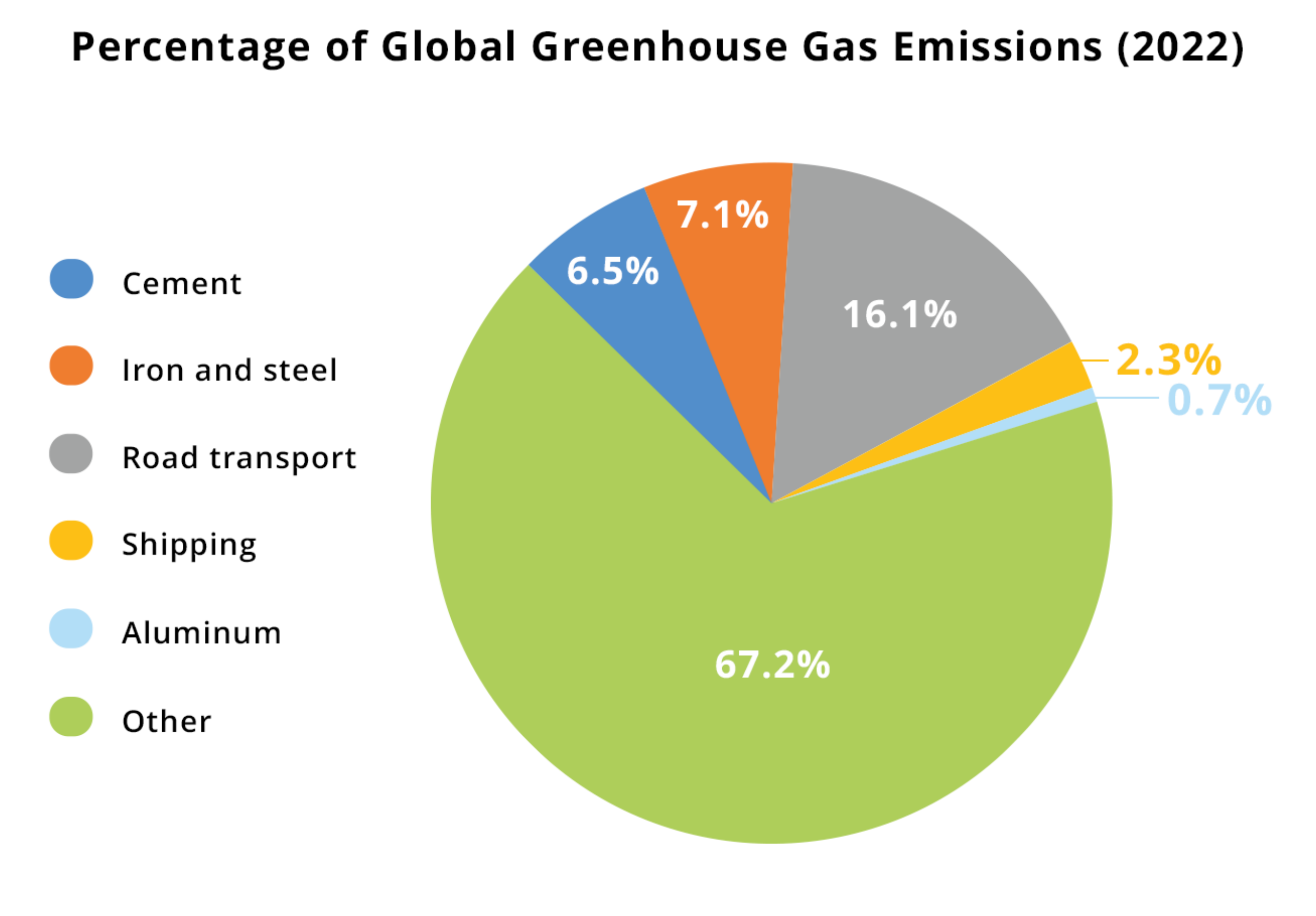
— Brian Funk, Head of Credit Research, MetLife Investment Management

An emerging opportunity

Increased government regulations, evolving consumer preferences and a growing pool of sustainability-focused investment dollars are driving companies to decarbonize. As a result, BloombergNEF estimates that energy transition investments increased 31% between 2021 and 2022, topping $1.2 trillion,[3] although this still falls short of the estimated $2.4 trillion to $3.8 trillion in annual investment needed over the next decade.[4]

"We are seeing a green capex arms race," Funk says. "These companies are in mature industries. When they think about deploying capital for a green future, it's not an easy choice. They can't fund it with free cash flow, and they will need to come to the credit markets. It will hurt their profits temporarily, but the companies that don't make the smart expenditures will get left behind."

As companies invest increasing volumes of capital to reduce emissions and boost sustainability, understanding how a business is responding to



Source: "World Energy Outlook 2023," International Energy Agency (IEA), 2023.

and planning for the transition is a critical part of an investment analysis. Automakers in the U.S., for example, are major credit issuers, and Funk estimates that the industry will spend upward of $75 billion in the next five years to convert their businesses to focus on electric vehicles. With so much capital on the line, identifying the likely winners of these transitions yields valuable investment insight.

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— Daniel Kricheff, Director, Global Credit Research-Sustainability, MetLife Investment Management

“The energy transition requires a fundamental shift in how investors think about sustainability,” says Daniel Kricheff, director of global credit research-sustainability at MetLife Investment Management. “The economic and policy tailwinds are already there, and how companies manage the transition will have long-term implications for their competitiveness.”

A new breed of analysis

Understanding how to analyze a company’s transition plans and incorporating that insight into an overall investment approach requires a set of skills that extends beyond traditional financial analysis.

Kricheff’s approach to sustainability analysis rests on bottom-up research. Companies are increasingly committing to publicly stated emissions goals, but you can’t always take those plans at face value. Instead, Kricheff and his team scrutinize the issuer’s plan, as well as details about the technology they plan to use and the costs they expect to incur. That information is used in conjunction with the scientific community’s research findings and projected climate-change scenarios.

Funk says uncovering opportunities using a sustainability lens is the first step in the transition finance process. The next step is to layer in a traditional credit analysis that can help identify the most appealing securities. But to do it well, he adds, you will need best-in-class sustainability verification. “The objective is to mobilize mainstream capital for environmental and social good, then build portfolios to manage risk and deliver competitive performance,” Funk says.

Sources

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2. “Climate Change and the Production of Iron and Steel,” World Steel Association, 2021.
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4. “Energy Transition Investment Trends 2023,” BloombergNEF, Jan. 26, 2023.

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