ifm investors

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INSIGHT

The investment risks of climate change

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CORPORATE

IFM Investors' purpose is to protect and grow the retirement savings of working people, and, as fiduciary investors, we believe it is in our financial interests to have a plan that addresses the risks of climate change: climate risks are investment risks.

Climate change has the potential to negatively impact the environmental, social and economic stability of nations globally, which in turn will damage value for long-term investors. While the impacts of climate change will play out over the coming decades, its impacts on natural and built environments, communities and economies around the world are being witnessed and experienced now, with Australia's and California's summer wild fires being a harsh reminder.

We believe it is in the interests of our investors and their members and beneficiaries to understand and mitigate these risks within our business and our portfolios, while accepting that the transition to a net zero emissions economy will take time. Our focus remains on limiting our emissions, managing and reducing risk and harnessing opportunities in the evolving global landscape.

This article - *The investment risks of climate change* - is the first in a 2-part series on climate-related investment risks. It covers how we assess and better understand climate-related investment risks across the asset classes in which we invest – infrastructure, equities, debt and private equity. The second article - *Managing climate related risk in investment portfolios* - explains how we are managing climate-related risks at the portfolio level, including what we have achieved already and what we hope to do in the future.

Following IFM's commitment to reduce greenhouse emissions across our asset classes, targeting net zero by 2050, we are conducting more detailed scenario analysis to further enhance our understanding of, and response to, climate-related physical and transition risks. We look forward to updating investors and other stakeholders in due course as we continue to learn and apply these insights to our investment decision-making and asset management practices.

Defining climate change-related investment risks

To better understand the key risks posed by climate change, the Taskforce for Climate-related Financial Disclosures (TCFD) divides climate-related impacts into two categories – transition risk and opportunity, and physical risks.

Transition risk and opportunity

Transition risks are those that result from transitioning to a lower-carbon economy. This may entail extensive policy, legal, technological and market changes aimed at mitigating greenhouse gas emissions to avoid dangerous climate change, or strategies to adapt to the impacts of climate change. Depending on the nature, speed, and focus of these changes, transition risks may pose varying levels of financial and reputational risk to organisations.

Transition-related opportunities also arise from efforts to mitigate and adapt to climate change. Examples include cost savings from increased resource efficiency, the adoption of low-emission energy sources, the development of new products and services and building resilience along the supply chain. These opportunities will vary depending on the region, market and industry in which an organisation operates.

Physical risks

Physical risks resulting from climate change can be event-driven (acute) or longer-term shifts (chronic) in climate patterns. Event-driven acute physical risks include the increased severity of extreme weather events, such as cyclones, hurricanes, floods or bushfires. Chronic physical risks are longer-term shifts in climate patterns (e.g. sustained higher temperatures) that may cause sea levels to rise or chronic heat waves.

Physical risks may have financial implications for organisations, such as direct damage to assets and indirect impacts from supply chain disruption.

Potential climate-related investment risks for infrastructure assets

- Increasing frequency of extreme weather events may heighten the risk of physical damage and associated costs to infrastructure assets.
- Infrastructure investors may need to review insurance coverage and uninsured loss implications, together with additional capital expenditure requirements.
- Severe weather events (e.g. heavy snowfall) may disrupt operations and/or supply chains, which can impact revenue.
- Adaptation and mitigation actions to increase the resilience of assets to physical climate risks may require increased investment from infrastructure owners going forward.
- Increasing regulation and/or changes in policy designed to curve the rise in greenhouse gas emissions and support low carbon technologies may impact the demand and cost associated with fossil fuel reliant products and services.
- Increasing environmental concerns may lead to delays/refusals for planned business expansion projects.
- A drop in demand for fossil fuel energy sources could potentially lead to asset stranding and/or loss of asset value.
- A shift in consumer preferences or market sentiment could lead to reputation damage for investors who don't recognise and actively manage their portfolios as the economy transitions.

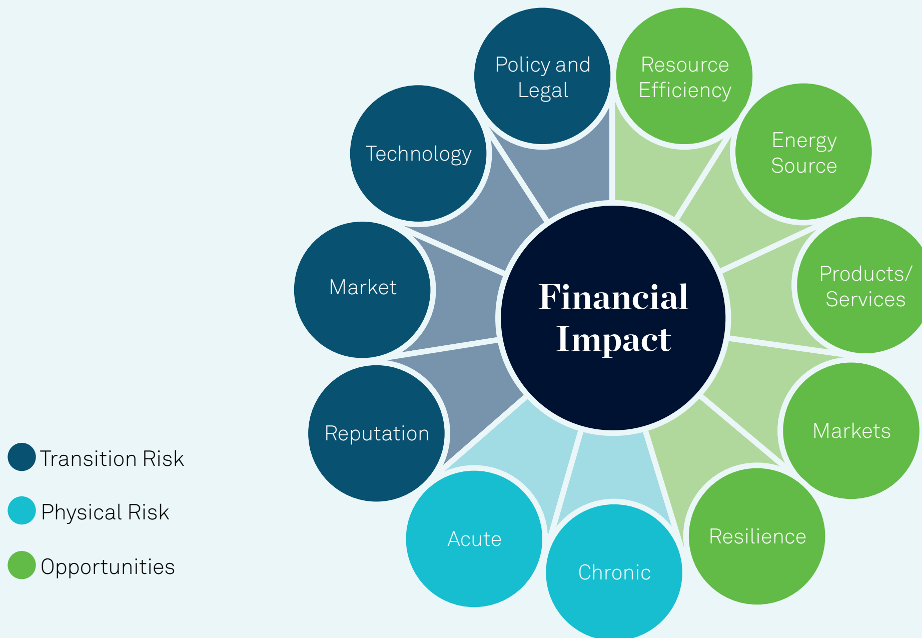
Transition and physical risks - an interdependent but inverse relationship

Whilst these two categories of risks can both have financial impacts on assets, they are quite distinct from one another. They are interdependent but also inversely related – the more effort made to prevent climate change now, the higher the transition risk exposure. However, if the world fails to start rapidly decarbonising the economy, limiting average temperature increases to well below 2 degrees Celsius as set out in the Paris Agreement, we believe transition risks will be lower,but the likelihood and consequences of physical impacts will rapidly increase.

> As supporters of the Paris Agreement, we explicitly factor climate change risk into all of our investment decisions.
>
> Chris Newton

FIGURE 01 CLIMATE-RELATED RISKS AND OPPORTUNITIES

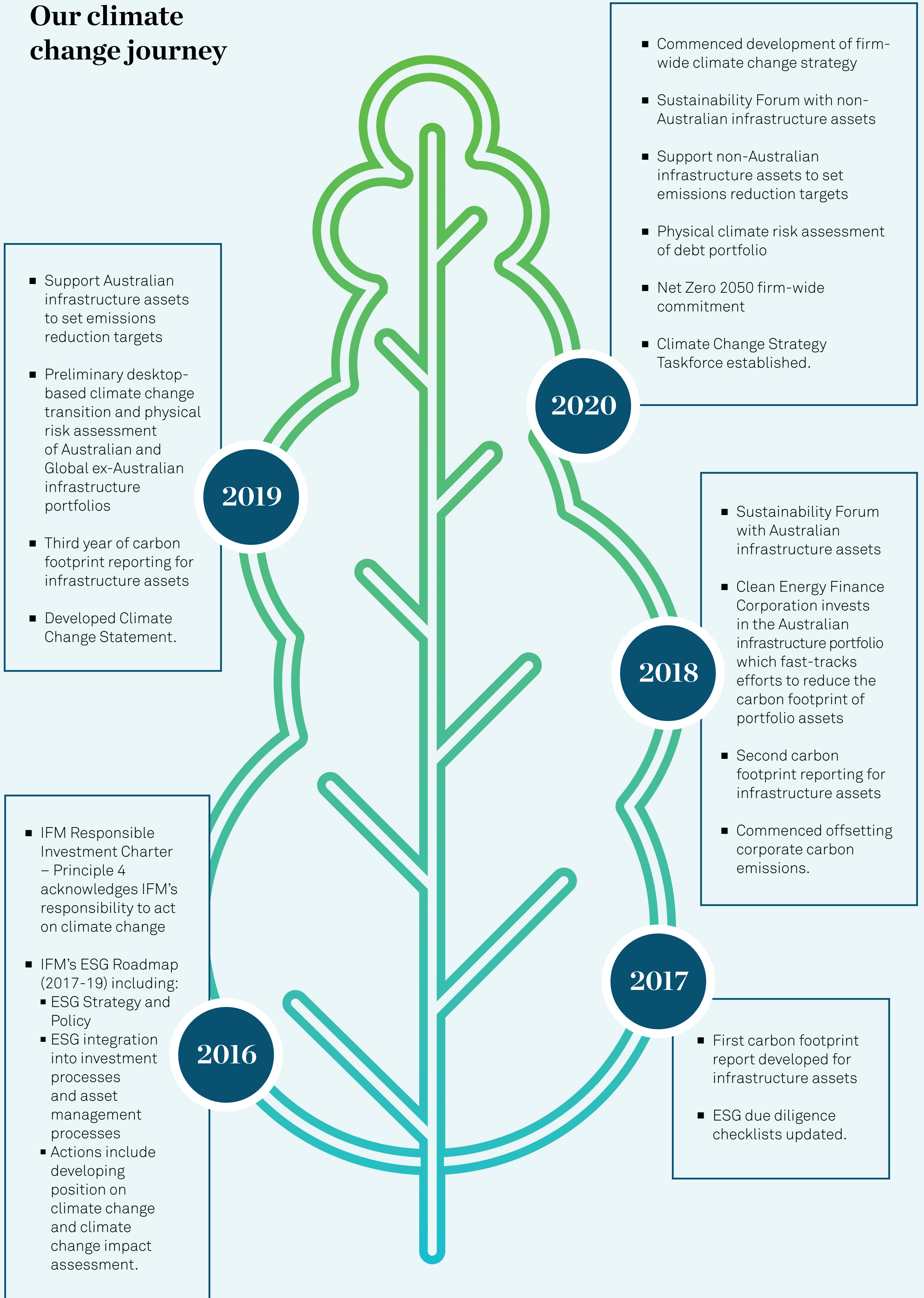
Climate-Related Risks, Opportunities and Financial Impact



Source: IFM Investors

As supporters of the Paris Agreement, we explicitly factor climate change risk into all of our investment decisions. We also engage and work with investee companies to support their transition to a low-carbon economy in ways that create positive environmental and social outcomes, and through those, better commercial and investment outcomes.

Our climate change journey



Understanding climate change risks and their portfolio impacts

Infrastructure

Within our infrastructure portfolio, we have the ability to drive climate change strategy with our co-shareholders, as we are part owners of the assets in which we invest and have board representation. Our climate change strategy in infrastructure
aims to:

- Measure and reduce our assets' carbon emissions;
- Identify and mitigate physical and transition risk exposures in our portfolio;
- Find opportunities at our assets that arise from changes in policy, technology and market dynamics associated with climate change.

In recent years, we have commenced detailed work to assess the risk exposure of our Australian and global infrastructure assets.

To date, we have focused on understanding high-level sector and asset level risk exposure under different climate change scenarios. For example, the physical impacts of climate change would increase significantly under a RCP 8.5 temperature scenario. Flooding and storms potentially pose the biggest risk and are likely to impact every sub-sector. Some sectors are likely to face multiple hazards, including extreme temperatures, water stress/drought, bushfires, extreme cold and landslides.

As part of the development of our firm-wide climate change strategy, we will be assessing our infrastructure portfolio against updated climate change scenarios, including a net zero by 2050 scenario, to enhance our understanding of both transition and physical risks.

Listed equities

As minority shareholders in listed companies, we do not have the same ability to drive companies' climate change strategies as we have in infrastructure. However, we are able to exert some influence though our voting and engagement strategy.

We believe active company engagement is critical to the advancement and promotion of responsible investment considerations, such as climate change. We have an intimate knowledge of our investments and regularly engage with businesses either directly, or through the Australian Council of Superannuation Investors (ACSI). We seek to encourage positive change in corporate behavior and we also frequently engage with regulators, industry associations and the investment community to promote best practice responsible investment standards.

We exercise our rights to vote on company resolutions within our listed equities portfolio to encourage responsible corporate behaviour and drive climate related initiatives that build shareholder value over the long term. We are also involved in collaborative engagement through organisations such as Climate Action 100+, which is an investor initiative that seeks to promote climate change action from global companies that are large emitters of greenhouse gases.

Within our infrastructure portfolio, we have the ability to drive climate change strategy as we are part owners of the assets in which we invest and have board representation.

Chris Newton

Debt investments

Since debt investors lend money to companies but do not have any ownership rights, they typically have less ability to influence company management over the life of the investment than equity and infrastructure investors. Therefore, assessing climate change risk in debt investing is typically concentrated in the investment screening and due diligence phases.

Early stage screening enables us to avoid investments that do not meet certain climate-related criteria, whilst our fuller due diligence in the underwriting process ensures that climate risks are appropriately elevated in our credit assessment.

We also monitor climate related themes (e.g. physical risks) within our debt portfolio on an ongoing basis. This enables us to identify risks across the portfolio and incorporate them into our decision making processes.

Assessing climate change risk in debt investing is typically concentrated in the investment screening and due diligence phases.

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Private equity

Within private equity, we usually hold a significant position in companies in which we invest, hence we have the ability to influence climate change strategy. Our investment approach focuses on service sector companies that are underpinned by strong technology and tend to have relatively low carbon footprints.

The Private Equity team liaises with the dedicated IFM Responsible Investment team early in the investment process to identify any potential ESG risks and opportunities. This includes climate change considerations. Actions to address any potential risks are then integrated into both the pre-acquisition due diligence process and the post-acquisition value creation work plans. The materiality of those risks and opportunities are then assessed on a live basis throughout the life of the investment.

How we are managing climate risk at the portfolio level

Look out for the second article in this series - *Managing climate related risk in investment portfolios* - which explains how we are managing climate related risks at the portfolio level, including what we have achieved already and what we plan to do in the future.

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