
Illustration by John Rego

ESG Analyst Survey 2023: Mind the gap

Foreword

When the going gets tough, you can see who's still committed to sustainable investing. And this year we report a mixed picture. Weaker economies and business performance, as well as emerging political scepticism on environmental, social and governance (ESG) in some countries, have formed a markedly different backdrop to the 2023 ESG Survey of Fidelity's analysts, compared with last year. On the one hand, it's clear the companies the analysts cover aren't moving fast enough, especially when it comes to meeting targets around net zero carbon emissions. On the other hand, as we already spotted last year, sustainability is embedding in many companies, gradually becoming the new normal.

The 123 analysts from across our Equities, Fixed Income, Private Credit, and Sustainable Investing teams who completed the survey don't rely on spreadsheets and quarterly updates from the companies we invest our clients' money in, they get out of the office and go to see for themselves. Meeting management teams, suppliers, and customers they ask how businesses are performing, checking claims against reality. It's what helps them build a deep expertise on companies and entire sectors. When that knowledge and experience is combined in a report it forms a powerful insight that we have shaped into this, our third ESG Survey.

What emerges is actionable: for politicians, a clear request for stringent and consistent regulation across the world. For companies, transparency and a view on where their efforts measure up to their rivals. And for investors, an awareness that companies in China are racing to catch up.

Richard Edgar
Editor in Chief

Survey Editors
Ben Traynor and Tobias Sims

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Mind the gap: Companies need to spend much more on net zero

Fidelity's third annual survey of our analysts on ESG issues delivers a home truth: there is a big gap between the action needed to deliver net zero and what the corporate world is currently doing.

Fiona O'Neill
Head of Global Cross-Asset Research Capabilities

The 2023 Fidelity International ESG Analyst Survey - our third - asks whether companies' net zero plans are credible. The answer is: not yet. There are gaps in technology, a shortage of ambition, and the money currently allocated to reducing carbon emissions is well short of what's required.

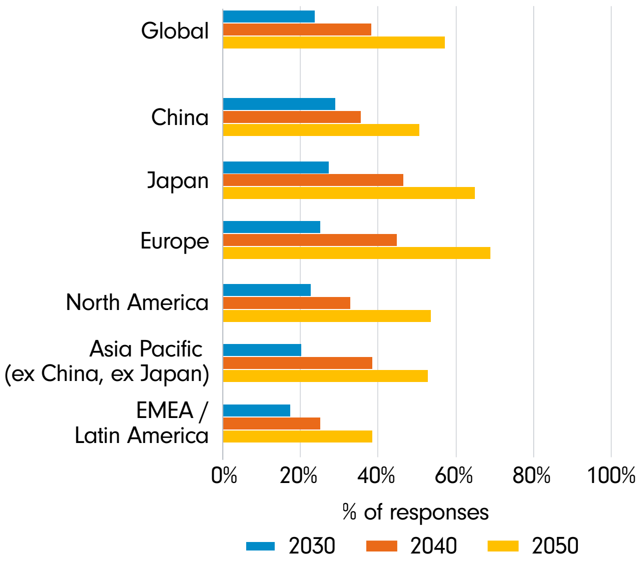
Currently, less than 60 per cent of companies are on track to cut their carbon emissions to net zero by the UN agreed target of 2050, according to our analysts' assessments of the companies they cover. And only one in four will do so by the more ambitious target of 2030.

That shouldn't detract from the progress that has been made. The world's big companies have, and are, listening, and the survey shows that most developed-world multinationals have committed to net zero targets, with 69 per cent of European companies allocating the funds needed to hit those targets by 2050.

But the survey tells us that the big multinationals that we invest in must up their game, and much of the impetus must come from governments.

"Although companies will get a return on their investment, they may not want to do the upfront spending," says Velislava Dimitrova, a portfolio manager who focuses on climate. "If we want to get to 100 per cent within the timeframe scientists say we have, we will need a regulatory push."

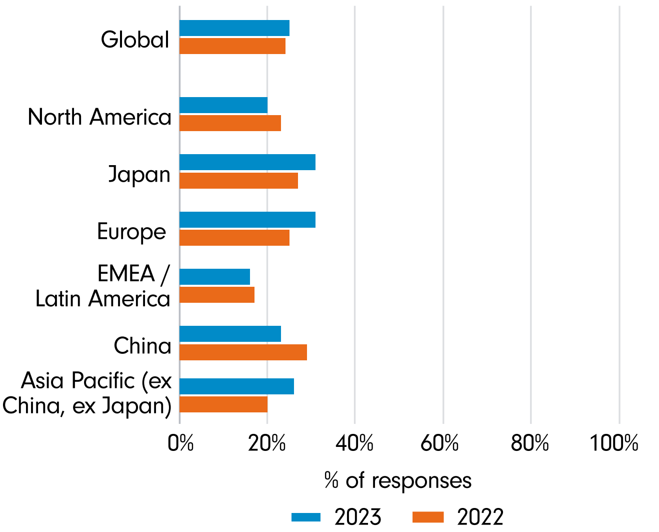
Chart 1: Most companies aren't spending enough to hit net zero



Question: "What proportion of your companies do you believe are allocating enough capex to achieve net zero by the following dates?" Source: Fidelity International ESG Analyst Survey 2023.

As Chart 2 below shows, we are one year closer to 2030 and our analysts' expectations for how many companies will hit net zero by that date has fallen slightly compared to last year on a global basis, although there appears to be more optimism around China.

Chart 2: Net zero by 2030 looks unrealistic for most companies



Question: "What proportion of your companies do you believe are allocating enough capex to achieve net zero by 2030?" Source: Fidelity International ESG Analyst Survey 2023. [Please note, this chart corrects previously published numbers. In our 2022 survey, a data error led to an overstatement of the results, for example the global figure was put at 35%, this has now been corrected to 25%]

Behind the headline numbers, as ever, is a complex mix of business- and policy-driven choices that vary widely across sectors and regions.

"In many cases the technology is not yet there," says Laura Stafford, an equity analyst who covers Latin America and Eastern Europe, Middle East and Africa (LatAm/EMEA) mining and commodities companies. "For those targeting net zero by 2050 they still don't have a clear roadmap of how to get there so it's impossible to say how much capital will even be needed."

Utilities stands out as a success story, with the opportunities in renewable power drawing huge investment. Our analysts judge that almost four out of five companies will reach the net zero target by 2050. In the energy sector, there is a clear split between European companies, which are pivoting towards renewables, and those covering North American energy firms.

"Our sector is at the heart of the problem," says Randy Cutler, a credit analyst focused on the US energy industry. "Some will transform. But others either can't get there or have decided they never will."

The survey data suggest that companies are gravitating towards areas where action is possible or easier

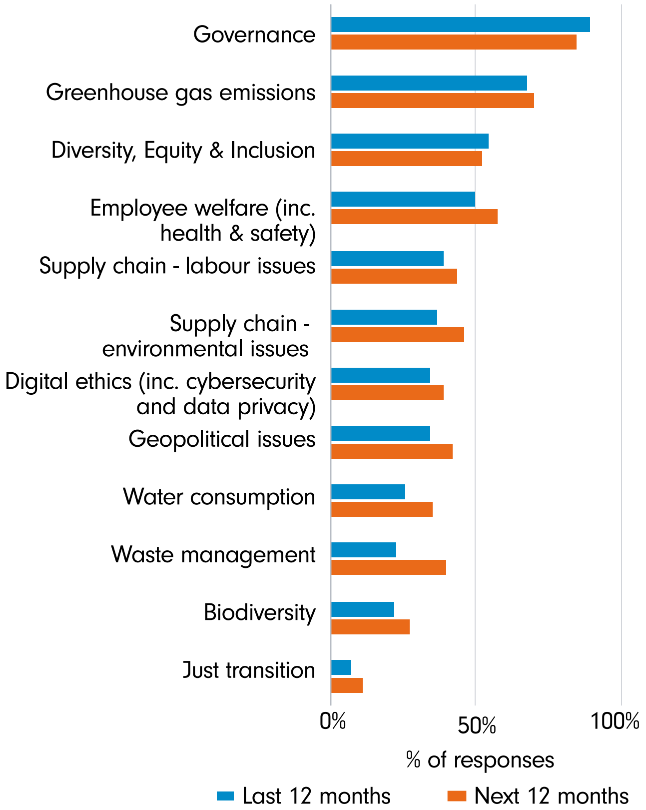
Recession threats are a distraction

In the immediate future, the stresses caused by the world's current weak economic situation will not help. As business conditions become tougher, managers will be under pressure to focus on immediate results over longer term sustainability.

"Most of my companies are either in default or deeply stressed. ESG has been low on their priorities and will very likely remain so in the next 12 months," says Ming Gong, an analyst who covers China's traumatised property sector.

The survey data suggest that companies are gravitating towards areas where action is possible or easier. They are still discussing thornier, harder to measure issues like biodiversity or the need for a just transition, but far less than, for example, corporate governance.

Chart 3: Governance and greenhouse gases still dominate engagement conversations



Questions: "What ESG issues have you engaged with companies on over the last 12 months?" and "What ESG issues do you expect to engage on over the next 12 months?" Source: Fidelity International ESG Analyst Survey 2023.

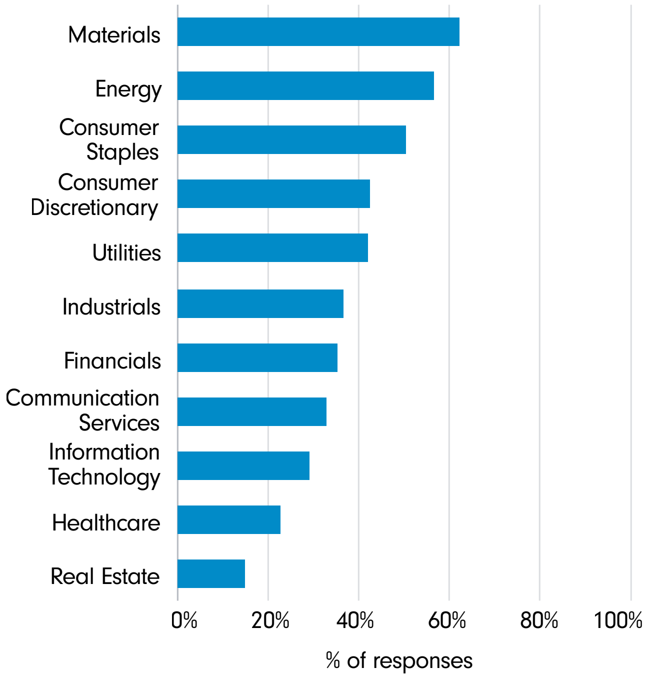
ESG now embedded in some sectors

Opportunities created by the energy transition continue to outnumber the threats to corporate businesses, however, and in a number of sectors ESG issues have become an unavoidable factor in day-to-day operations and business strategy.

"In areas like building materials distribution, smaller players can't invest as much as their big peers in their ESG credentials, which are becoming increasingly more important in tender processes," says Serhat Birbilen, who covers European consumer discretionary firms. "Big companies like Travis Perkins, which can afford ESG investments, have already started taking share from those smaller players. So ESG might already be consolidating some markets."

Other indicators similarly point to a maturing of corporate behaviour around ESG. Our analysts estimate that 39 per cent of the 15,000 meetings they have with companies every year now include engagement on ESG issues.

Chart 4: ESG on the agenda at many company meetings



Question: "What percentage of your company meetings have included engagement on an ESG topic in the last 12 months?" Source: Fidelity International ESG Analyst Survey 2023.

Analysts are also realistic about where they are having an impact, with investor engagement ranked as the top factor influencing changes to governance, but further down the list on social and environmental issues. Regulation and government policy are seen as the main factors driving change as we head deeper into the transition. Government incentives are almost as important but free markets and consumers themselves are not providing the necessary impetus. This is writ large in China, where the government's pledge to make the country carbon neutral by 2060 is driving a sea change in company commitments.

Overpolished credentials

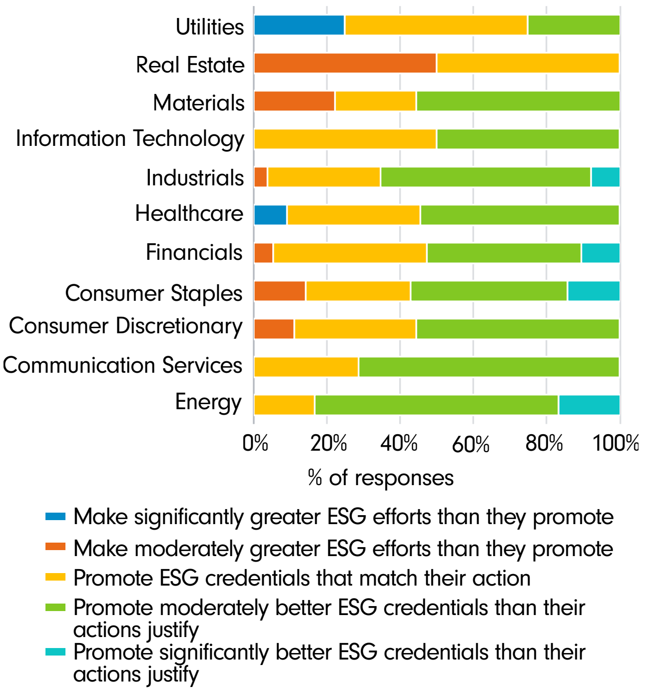
The proportion of meetings with c-suite executives has dipped slightly for the third year running[1] as companies build out sustainability teams. But 73 per cent of analysts say companies are responsive on ESG issues, a figure that has been steadily climbing since we started this survey two years ago. More than half of respondents say management remuneration is now linked to emission targets and the survey suggests that more than 60 per cent of companies now have board level oversight of sustainability.

At the same time, however, there is some cynical behaviour: almost 60 per cent of our analysts estimate that their companies promote ESG credentials not backed up by their actions. Last year, around half of our analysts made the same assessment, suggesting that overpromotion of ESG credentials may be growing more common.

"Usually, the mismatch is in promoting or emphasising only the clean aspect of a company's business, when most of what they do remains in non-sustainable categories," says Paul Milon, a sustainable investing analyst who covers Asia Pacific (ex China, ex Japan, ex Australia). "There's a mismatch due to selective communication."

Typically, it is the sectors where companies are performing poorly where this is more visible. In the energy sector, 83 per cent of analysts say their companies moderately or significantly overstate their credentials.

Chart 5: What they say and what they do



Question: "Thinking about your companies' efforts to promote their ESG credentials, which of the following would you say companies typically do? Chart shows percentage of analysts. Source: Fidelity International ESG Analyst Survey 2023.

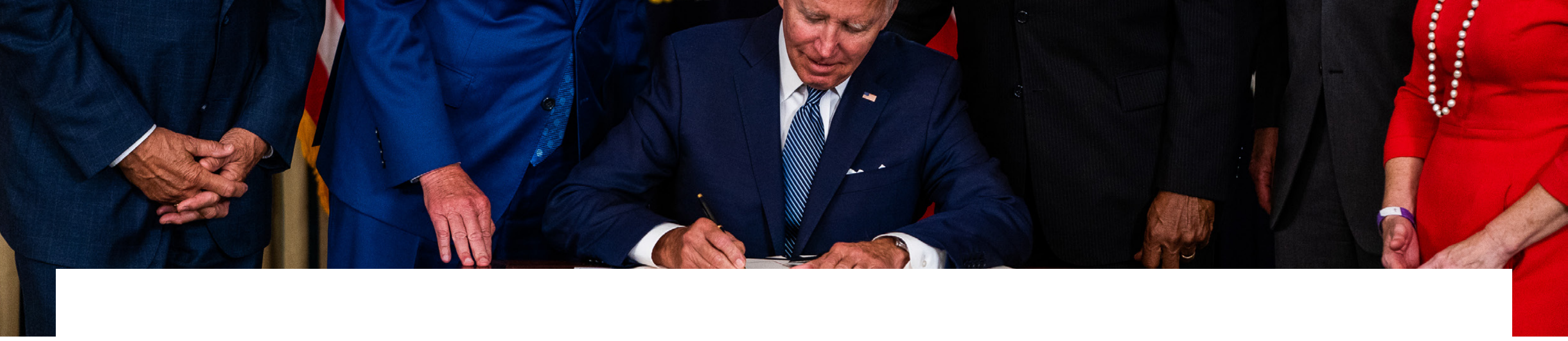
Trade offs abound

The transition to a better social and environmental state is complicated and often involves trade offs. Solar panels are better than energy from fossil fuels but some panels are made with forced labour; banks in the developed world boast they are offering easier access to finance - but vulnerable customers are often being overcharged.

These problems and contradictions are emerging with time and resolving them is part of the maturing of the transition. But it is maturing. When companies first started making pledges, they were just that: vague promises that we had no way of testing. We have some data now and the discussion is becoming more concrete. The devil will be in the detail. What is crystal clear, as our survey shows, is that much more needs to be done than is currently the case.

[1]NB A data error last year meant we erroneously reported the proportion had grown slightly.

Government regulation will drive real change in ESG



One of the strongest messages communicated by our analysts in this year's ESG Survey is the effectiveness of government regulation in changing companies' behaviour. While investors, consumers, employees, and competitors all have a role to play in shifting practices, it is only regulatory updates that can compel businesses to improve.

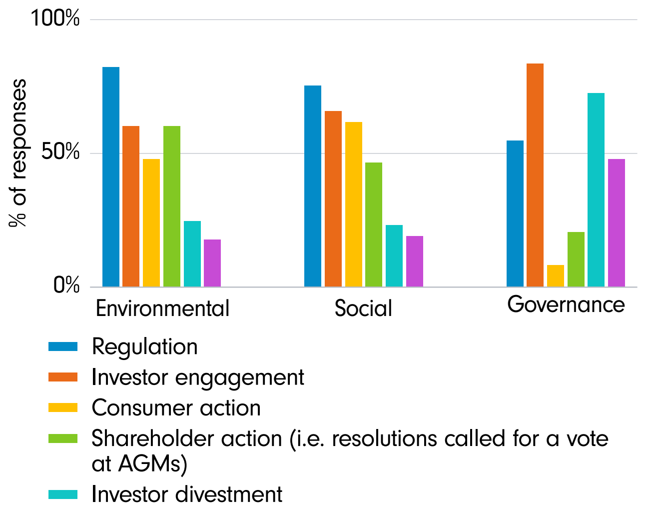
Gita Bal
Global Head of Fixed Income Research

The three years over which we have run the ESG Survey have been some of the strangest and most difficult I've seen across the financial markets. Beginning in 2021 when much of the world was still locked down, our analysts followed their sectors through a war in Europe, supply chain crises, and rampant inflation. And despite these existential challenges, they have tracked tangible and heartening improvements in companies' ESG profiles.

But it is clear from this year's survey that the looming threat of a recession has now slowed progress and that the financing necessary for companies to meet their net zero goals is seriously lacking. The survey does offer insights from Fidelity's analysts as to how this gap can be overcome, however.

Leading the charge is government policy. Over 60 per cent of our analysts said that regulation was one of the top three most important factors for driving change in environmental, social, and governance practices.

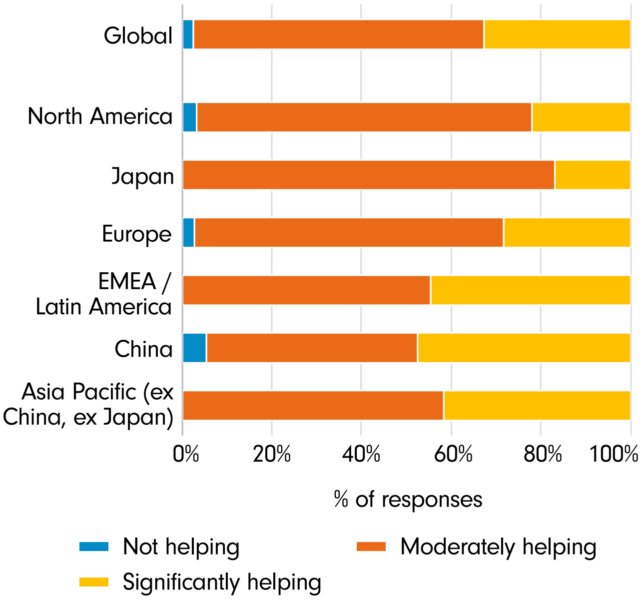
Chart 6: Regulation and incentives among top drivers of change across ESG practices



Questions: "What do you think will drive changes in environmental practices at your companies over the next 12 months?"; "What do you think will drive changes in social practices at your companies over the next 12 months?"; "What do you think will drive changes in governance practices at your companies over the next 12 months?". Chart shows the proportion ranking each factor as one of the top three most important for each question. Source: Fidelity International ESG Analyst Survey 2023.

This dynamic is particularly noticeable in China, where the government's pledge to make the country carbon neutral by 2060 has shown the power of top-down intervention.

Chart 7: Vast majority agree government regulation helps to accelerate progress



Question: "To what extent do you think ESG regulation is helping companies accelerate the shift towards net zero?" N.B. no analysts selected "hindering" as an option. Source: Fidelity International ESG Analyst Survey 2023.

Where next?

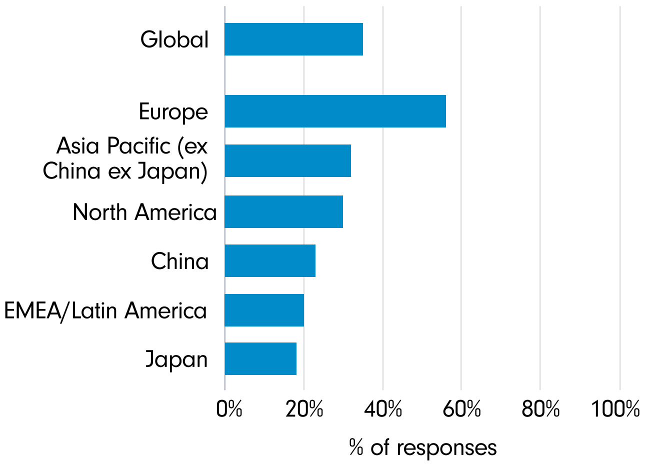
Our analysts have identified a range of both push and pull policies that they think will ensure companies improve their practices. Tristan Purcell, an equity research analyst focusing on European industrials, recognises that more stringent building regulation and the faster enforced adoption of renewables in power generation are two of the clearest, already proven methods for driving change, for example.

Harriet Wildgoose, an analyst in our sustainable investing team, notes that in agriculture and across food systems – segments that generate around a third of our greenhouse gas emissions[2] – current incentives are "often misaligned with net zero and nature goals and need to be redirected at the national and regional level towards solutions such as regenerative farming techniques."

Other suggestions from our analysts across industries range eclectically from enforcing the recycling of mattresses to offering rebates on the installation of heat pumps.

One common theme that emerges is that the alignment of standards across different jurisdictions is critical, with repeated calls from our analysts for carbon to be priced effectively. Pricing in carbon markets is inefficient: companies are able to tap into artificially cheap sources that do not necessarily offset their emissions, and there is little standardisation in the way the market operates across different regions. The EU is leading the way on clarity, and better language has been included in the US's Inflation Reduction Act, but leadership is still needed to create a productive level playing field across the world.

Chart 8: Carbon markets rarely utilised



Question: "What percentage of your companies use carbon markets as part of their net zero plans?" Source: Fidelity International ESG Analyst Survey 2023.

Currently, only around a quarter of companies in Fidelity's coverage use carbon markets as part of their net zero plans.

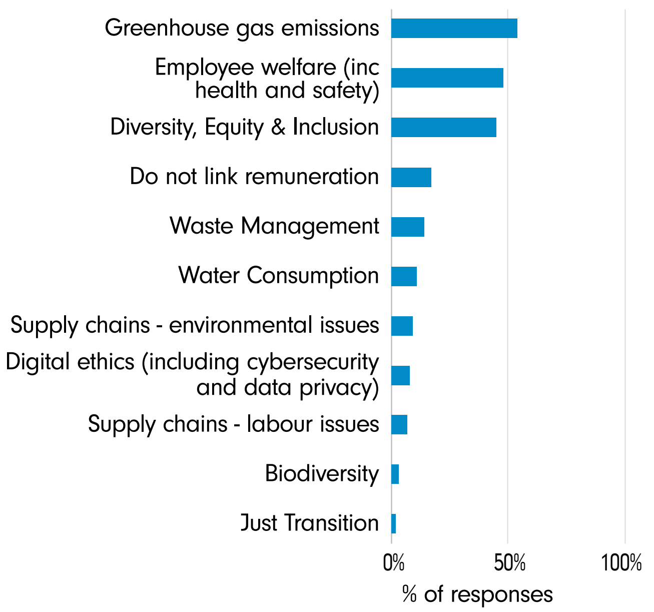
[2]Food systems are responsible for a third of global anthropogenic GHG emissions, NatureFood, March 2021

Taking the measure of things

Sometimes, the most effective regulation can be as simple as requiring companies to measure (and report on) relevant criteria. A cruise line operator I once covered as an analyst didn't measure anything, whether their ships' carbon emissions or something as seemingly trivial as how many plastics straws they were using. But the moment they started tracking their performance it triggered changes in their practices and an immediate reduction in the waste they generated.

Similarly, since companies have had to report their greenhouse gas emissions they have pushed hard to cut those figures. Even more powerful, perhaps, is that this is now the most common sustainability metric linked to senior management teams' remuneration. Regulation insisting that firms measure and disclose diversity and inclusion data means that this has also become a popular metric on which to base compensation.

Chart 9: Senior management pay most frequently linked to emissions



Question: "Do your companies currently link the remuneration of senior management to any of the following ESG issues?" Source: Fidelity International ESG Analyst Survey 2023.

In contrast, on an issue such as biodiversity, there are far fewer required standards for companies to adhere to. As a result, there is a lag in the development of reliable metrics, fewer companies measure their activity, and fewer still pin senior managers' pay to biodiversity targets. Given progress has been so slow around biodiversity, the potential gains from simple regulatory changes in this area could be significant.

Getting engaged

While regulation is essential, the financial world also has an important role to play. A majority of analysts report that investor engagement and shareholder action are among the most effective ways of encouraging change in governance, and around half place engagement as one of the top three ways to improve environmental and social practices.

Certainly, there have been many instances where Fidelity's intervention has prompted specific and meaningful change, such as the collaborative engagement we led with mining conglomerate Grupo Mexico which saw the company publish new emissions targets including a net zero goal for 2050.

Other approaches to help steer the corporate world to a more sustainable future include more intangible elements that are harder to measure such as companies' willingness to benchmark with global peers, a desire to attract employees, or social or client pressures, all of which can trigger big improvements on their own.

But top-down intervention is the magic ingredient. As an investor and a consumer, I want to see improvements in the world and will push for those in all the ways I'm able, but it is governments that can mandate real change with the most effective results.

The Chinese character of sustainable investing

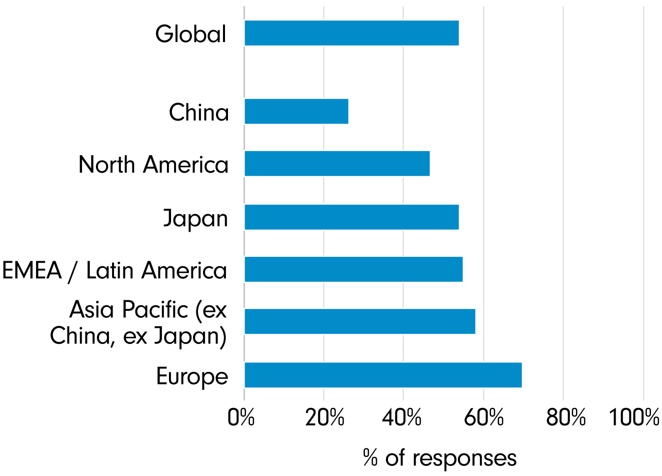
China is not as far along its path to implementing sustainability principles as some other regions in our survey. But for investors, this should be both a call to action and a cause for optimism.

Victoria Mio
Head of Equity Research, Asia

Some of the shine may be wearing off sustainable investing in the west, but China appears to be at an altogether earlier and more optimistic stage of its journey.

ESG factors have been rising steadily up the priority list for management teams in China for some time, albeit from a low base. But this embrace has taken on new urgency since 2020, when President Xi Jinping issued a pledge that the country would hit peak CO2 emissions by 2030 and achieve carbon neutrality by 2060.

Chart 10: Chinese companies play catchup on net zero goals



Question: "What percentage of your companies have a net zero goal?" Source: Fidelity International ESG Analyst Survey 2023.

For all its positive implications, Xi's net zero pledge also presents clear top-down challenges for firms that have yet to fall in line. Our sector analysts who focus on Chinese companies say that only about a quarter of those they cover have a net zero goal in place, compared with a global average of just over half of all companies under coverage. While that figure can't be directly extrapolated to represent all businesses in China, it does point towards a need for prompt action. "Chinese companies have a lot of catching up to do, and fast, if they are to get in-step with the government's targets for cutting emissions at the national level," says Flora Wang, Head of Stewardship for Asia at Fidelity International.

Targeting results

But in China, where there's a political will, there's a way: nearly half of the survey respondents covering the country said regulation was "significantly helping" to boost their companies' shifts to net zero, the highest for any region.

Anecdotally, there's scope to amplify this top-down regulatory push and maximise its impact. "One challenge that I find when engaging with my companies is that national targets often haven't been cascaded down to local levels," says Wen Wei Tow, a fixed income analyst in Shanghai who covers local government financing vehicles. "The result is that companies sometimes lack action plans or resources to help them lower their carbon footprints, so improving this would be one way to accelerate the green transition."

While it may still be early days, China's energy transition is creating a swath of opportunities for investors. Already, fast movers among Chinese companies tapping green opportunities are starting to consolidate their positions in this rapidly evolving marketplace.

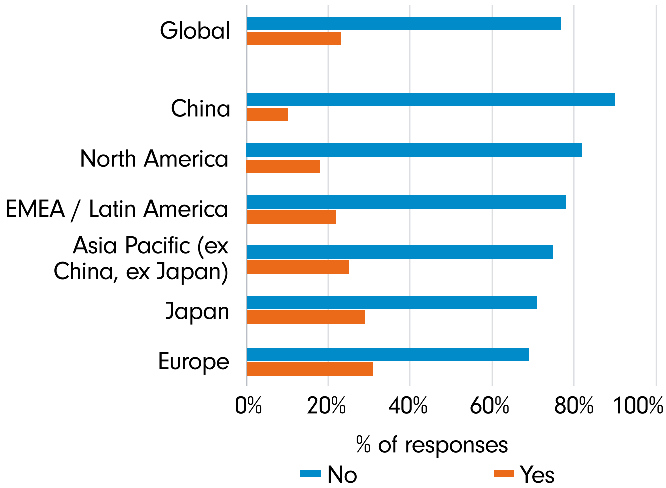
Other China sector analysts see opportunities to expand in waste and water management, or in the domestic banking sector as it ramps up lending to low carbon sectors

Consider electric vehicles. China already ranks as the world's biggest market for EVs by sales volumes, but the balance is quickly swinging towards nimble homegrown competitors. "Domestic auto manufacturers are building new EV brands and products to take market share from global brands," says Eric Tse, an equity analyst covering China's carmakers and battery manufacturers based in Hong Kong. "Battery makers are taking advantage of burgeoning demand stemming from the rollout of solar, wind and other renewable power installations, which need to be paired with energy storage solutions so they can keep delivering uninterrupted power when the sun isn't shining, and the wind isn't blowing."

Other China sector analysts see opportunities to expand in waste and water management, or in the domestic banking sector as it ramps up lending to low carbon sectors.

Room to grow

Chart 11: Markets have scope to better reward China's ESG improvers



Question: "Have you seen any examples of an improvement in a company's cost of capital as a result of an improvement in its ESG profile?" Source: Fidelity International ESG Analyst Survey 2023.

While the regulatory imperatives to adopt greener practices in China are strong, companies don't always appear to have a similar set of compelling market-based incentives for making the transition. For example, our survey finds that companies in China are the least likely to see a reduction in their costs of capital as a result of improving their ESG profile. This in turn disincentives companies to make outside parties aware of the (often good) sustainability practices they are already employing.

“There’s clearly room for Chinese companies to expand and deepen their ESG disclosure and how they are rated by external providers of sustainability ratings,” says Alex Dong, an equity analyst based in Shanghai who covers companies in the construction materials and machinery sector.

This lack of a pricing reaction function though is consistent with other trends we’ve observed in the Chinese market, such as the absence of a so-called 'greenium' or price premium of green bonds over non-green debt from the same issuer.

Other areas where we see room to grow and develop include carbon trading. Fewer than 10 per cent of our analysts say Chinese companies use carbon trading as part of their net zero plans, which is the lowest level among all regions. This is partly due to the recency of the country’s national carbon emissions trading market and its restricted availability to only those companies engaged in the power sector. “China’s initiatives on carbon neutrality and greater development on carbon trading will help encourage enterprises to adopt more energy transition related policy and practices,” says Theresa Zhou, a Hong Kong-based equities analyst covering Chinese industrial companies.

Aim high

Of all regions in our survey, China arguably has the most capacity to move the dial on the implementation of sustainability, especially when it comes to cutting greenhouse gas emissions. But by the same token, Chinese corporates usually also have more ground to cover when it comes to keeping pace with counterparts in the US or Europe. We’ve highlighted a few areas where China has good prospects for closing the gap. There are many others. And the targets couldn’t be clearer.

Workers at a construction site of a zero-carbon demonstration zone. (Credit: VCG / Contributor, Getty Images)

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