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Transition Finance:

Investing in the Transition to a Low Carbon Economy

Introduction

Transition finance, which applies a sustainable investment strategy to some of the world's most greenhouse gas (GHG) intensive industries, aims to provide an innovative and high impact opportunity for investors to leverage capital at scale to support the transition to the low carbon industries and technologies of the future. Transition finance does this by targeting companies and entities across the economy which have aligned their operations and business models with the decarbonization pathways established by the scientific community to achieve the targets set out in the Paris Agreement—an international treaty adopted by 196 parties at the 2016 United Nations Climate Change Conference. This note discusses the potential of transition finance as an investment opportunity and introduces MetLife Investment Management's (MIM) Transition Strategy, a new research-driven, forward-looking strategy to mobilize capital at scale to support the energy transition while targeting outperformance[1] for fixed income portfolios.

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Defining the Challenge

To achieve the Paris Agreement objective to limit global warming to 1.5oC by the end of the century, the Intergovernmental Panel on Climate Change (IPCC) states that global GHG emissions will have to peak by 2025, before declining by 43% by 2030 and reaching net zero by the early 2050s. Achieving this will require addressing GHG emissions across all areas of the economy, including hard to abate sectors such as steel, cement, transport and buildings. Climate change is an economy-wide, whole system challenge and will be solved through innovation and ambition in hard to abate sectors as much as in already green assets and activities.

The investment needed to finance the transition will be significant. According to Bloomberg New Energy Finance (BNEF), global energy transition investment in 2022 was US$1.1tn, approaching the level of fossil fuel investment for the first time. Between 2023 and 2030, independent modelling from BNEF, the International Energy Agency (IEA) and the Network for Greening the Financial System (NGFS) estimate that annual investments required across a range of activities needed to achieve the energy transition could range from US$2.4tn to as much as US$3.8tn, with sustained levels of investment continuing through 2050 and beyond.[2]

Taking a Whole System Approach

For many economic activities and industries, the solution to climate change is relatively straightforward: shift to low carbon sources of energy and find ways to use energy more efficiently. Yet there are remaining challenges within the global energy system beyond renewable electricity. Nowhere are these challenges more complex and the opportunities as large than within hard to abate sectors—critical industries which account for a significant share of global GHG emissions, but for which technological solutions are either still nascent, or require significant capital investment and support to reach deployment at scale and cost parity with existing fossil fuel-based processes.

The challenges and opportunities for decarbonization are diverse across sectors. Steel, cement, aluminum and chemicals will each require a fundamental transformation in industrial processes, while addressing GHG emissions in the transport sector will be achieved through a shift in the source of power for mobility, whether that be through electrification, use of sustainable fuels or hydrogen fuel cells. Achieving this at scale will require what the IPCC calls a "whole-system transformation",[3] focusing on interdependencies and leveraging support from companies, policymakers and investors. Climate change is a system challenge as much as a technology challenge and cannot be addressed by any one entity or industry, nor by industries acting in isolation.

The MIM Transition Strategy: Assessing Ambition and Identifying Leaders

The MIM Transition Strategy is designed to research and identify companies and assets across the economy which are taking credible steps to reduce their GHG emissions to net zero, and those providing the products, services and infrastructure which will enable decarbonization more broadly. The MIM Transition Strategy is focused on investments which fall within four pillars:

1. Hard to Abate: Critical industries which account for a significant share of global GHG emissions, but for which technological solutions are either nascent, or require significant capital investment and support to reach deployment at scale and cost parity with existing fossil fuel-based processes.
2. Transition Enabling: Products, services, technology, and infrastructure which enable, support or facilitate decarbonization.
3. Transition Aligned: Companies undertaking ambitious steps to integrate climate change mitigation and risk management into their long-term business strategy to align their GHG emissions with the Paris Agreement targets.
4. Adaptation and Resilience: Critical infrastructure and activities, such as water, waste management and agriculture which are vulnerable to effects of climate change.

Achieving GHG emissions reductions at the scale required by the Paris Agreement will require a forward-looking strategy, with the objective of today's investments resulting in tomorrow's clean industries. This is particularly true within hard to abate sectors, where progress will be measured in years and decades, in some cases beyond the time horizon of a typical investment cycle. We therefore assess companies not only on where they are, but also on where we believe they are going. MIM will bring a track record of applying research-driven sustainability analysis to assess ambition and identify transition leaders and investment opportunities from across the economy.

The Energy Transition: A Long-term Capital Trend?

With global energy transition investment topping US$1tn in 2022,[4] the transition is increasingly taking on the shape of a long-term capital trend.[5] Economies of scale are catapulting low carbon solutions into the mainstream and attracting capital faster than previously anticipated: the increasing cost competitiveness of renewable energy and zero emissions vehicles are two cases in point. At the same time, legislative and regulatory developments are providing a significant boost for innovation in the real economy and for further flows of investment. The Inflation Reduction Act's US$500bn in incentives and tax breaks for low carbon solutions and recent developments in the European Union and elsewhere will help attract further investment to stimulate decarbonization of industry and support innovation. In the long-term, industries and companies investing in a transition strategy today may find themselves less exposed to regulatory risks and better positioned to benefit from the significant flows of public and private capital into low carbon solutions.

The energy transition will have far reaching impacts across all areas of the economy. These impacts will be non-linear and hard to predict with a high degree of granularity, however the longer trend will be toward increasing opportunities for companies with the ability to meet global demand for low carbon goods and services. Transition finance seeks to identify opportunities across all industries – including hard to abate sectors such as energy, basic materials, and transport. We believe a powerful long-term trend has begun, which will present a significant opportunity for investors to target outperformance1 for fixed income portfolios while mobilizing capital at scale to support the low carbon transition.

Endnotes

1 We believe anyone using a "transition risk strategy" is managing the upside/downside of transition risk and should therefore outperform those that are not, whether that is in U.S. dollar investment grade corporate bonds, high yield European corporate bonds, or emerging market bonds
2 BNEF (2023) Energy Transition Investment Trends 2023.
3 https://www.ipcc.ch/site/assets/uploads/sites/2/2022/06/SR15_Chapter_2_LR.pdf
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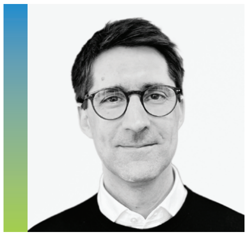
5 https://www.weforum.org/agenda/2023/02/energy-transition-investment-record-global-energy-crisis-3-february/

Author



Daniel Kricheff
Director, Credit Research – Sustainability
MetLife Investment Management

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