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EP 126 | Europe, Energy, ESG: Observations from the road

Rob Campbell (00:00):

Coming up on the podcast, I'm joined by one of our equity analysts, Stas Lopata, to talk all things Europe. Europe was at the epicenter of some of the most noteworthy developments in 2022 largely tied to the fallout from Russia's invasion of Ukraine. Stas is the perfect guest as he's been on the ground in Europe quite a bit over the past year. Our conversation touches on what governments and businesses are doing to deal with an energy crisis and sharply higher costs of living. But Stas also walks us through the complicated interplay between the environmental and social considerations that Europe's challenges present, as well as why some European companies may be better suited to adapt than others.

After we spoke, I found myself coming back to two of Stas's ideas. First, that many European companies have been in business for centuries. Working through challenging periods is just a part of their DNA. And then second's that while some things renew in 2022, much of what we're seeing play out today may have already been in motion. In other words, an acceleration of preexisting trends. Hope you enjoy.

Disclaimer (01:19):

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Rob Campbell (01:36):

Stas, great to see you. Welcome back to the podcast.

Stas Lopata (01:38):

Thank you very much, Rob.

Rob Campbell (01:39):

We are here to talk about Europe, definitely a point of interest for many of our clients given that our portfolios have pretty healthy allocations to companies based in the UK and in Europe. And headlines in 2022 is, most of our listeners probably know, have been quite negative, sometimes hyperbolic. Now, you've spent a lot of time in Europe this year. And so to kick things off, just wondering if you can set the stage for us from a macro perspective in terms of some of the main challenges facing the continent.

Stas Lopata (02:10):

I travelled to Europe on multiple occasions this year, meeting about 45 companies across the UK, Northern and Central Europe. At this time, Europe is experiencing [a] rapidly rising cost-of-living crisis. Energy bills are going up for companies and consumers, so it's a challenging situation. They're seeing inflation like the rest of the world, but they're also experiencing a level of significant increase in energy prices on top of that. For example, just to put it in context, [the] electricity bill for an average household is up three times this year. And then if this rate continues to carry on into the next year, [the] average household is estimated to have to pay £2000 more per year just for electricity bills alone.

Rob Campbell (02:55):

I was chatting with Patrick, one of our other colleagues—he was actually just in Belgium a couple of weeks ago, but his perspective was [from] being on the ground, and maybe it's just because there [had been] a World Cup game on when he was there—but his perspective was that it just didn't feel like there was a recession or real headwinds when he was there at the time.

Has that been your feeling as well on the ground in Europe? That these things are headwinds but have yet to really impact these cost-of-living aspects just yet?

Stas Lopata (03:22):

What is interesting talking to people on the ground in Italy, in the UK—there is a sense of calm among the general population. And I think there is a belief that the government will step in and do the right thing somehow. That some way, one way or another, the government will resolve the issue. And consumers, interestingly, the ones I talked to, just individuals and companies and talking to even taxi drivers—yes, it's challenging. And what they continue to repeat is, "We have to go through this together as Europe because individually, there is no way. Collectively, we have to collaborate. Corporate and the government should do its part."

And yes, in the UK, [the] government is in a bit of a mess right now, but still there is a sense of belief that they will get through this.

Rob Campbell (04:12):

I think we'll certainly talk about some of those interlinkages with respect to the power grids a little bit later. But then just to go back to your general sense of Europe, take us from the top-down to the bottom-up with respect to some of the companies that you've been speaking to.

Stas Lopata (04:25):

Definitely from a top-down perspective, [it's a] difficult challenging environment. From a bottom-up perspective, we see quite a different picture. Meeting with companies, as I said, there are about 45 companies I've met over the last eight months. There is a difference between the top-down macro and the bottom-up performance of the companies. There are multiple reasons for that.

Stas Lopata (05:00):

One, we have a number of companies in Europe, but these companies serve customers around the world. So, for example, in the UK we have a number of companies [we like in the] UK for the governance aspect because management teams are effective, they understand corporate governance and how to run the business well. And the British companies that we own—actually about 94% of their revenue on average is outside of the UK. So these are global businesses. Across the EAFE strategy on a look-through basis, the split in revenue is one-third in Europe, one-third in North America, and one-third is the rest of the world. So, one component is geographical diversification.

Secondly, many of these European companies, what stood out to me—they're more than 100 years old. A large number of companies I met with, Kuehne+Nagel, Lonza, Givaudan, SGS, Reckitt, these companies have been in the business for more than 100 years. In some cases, more than 200 years. So, I think one of the themes talking to management teams is they've actually lived through many different environments. They have collective corporate memory. And in some cases, these businesses have lived through two World Wars, periods of high inflation, even multiple recessions. So I think the culture within Europe is they've prepared for pretty bleak environment, and they have multiple things in place to mitigate the challenges. And so I think they're going through this and they're adapting.

Rob Campbell (06:20):

That's such a fascinating point to think about because clearly over the last 100 or 200 years, there have been a lot of challenges. But your point is that that resilience has been ingrained in the corporate cultures despite the fact that, take World War II for instance, nobody at those companies today were working for those companies or in executive positions at that time. That legacy has persisted despite the fact that the environment in Europe has been quite benign and peaceful for most last half century.

Stas Lopata (06:48):

I think [it's] also partly the nature of the businesses that they're in. Anglo American is a miner, and it's been in the business for more than 100 years. And so a lot of their mines are outside of Europe. They're also commodities. [Throughout] world history, in war times and peace times, there is demand for commodities. We have other examples like Roche, [which] has been a pharmaceutical [company] supplying medications through difficult periods in the economy and good times.

So, it also helps that the businesses that they're in, I think they've survived many environments and have shown to be resilient to many challenges.

I think also the important component about European businesses that we see today is, in business in general, there are three ways to compete. One is on costs, and China is very good at competing business away from a lot of companies because they are low cost. Another one is differentiation, where companies do something than others cannot. And the third one is operational effectiveness to create superior value for customers.

European businesses that we are in tend to do the last two, which is differentiation and operational effectiveness. And I think these businesses are fluid enough and they're global enough to adjust to pressures in certain regions and geographies.

Rob Campbell (08:11):

I think I've got a pretty good sense on the differentiation side—like a strong brand comes to mind with respect to some of those companies. Can you expand a bit more on the differentiation side where it might be a little bit less obvious with respect to where that differentiation is coming from?

Stas Lopata (08:24):

Yes, I mentioned Anglo American is a miner. They produce iron ore, copper, precious metals. On the surface, it's a commodity business with very little differentiation and then [they] compete in cost. And Anglo American is good at operating their mines sufficiently. What is less obvious is the type of iron ore, for example, that they produce.

So, iron ore typically in the market, there is a grade of purity. 64% to 65% is what Anglo American has. The industry average is 60% and the low end is 55%. So, there is about 10% difference in the grade of iron ore.

Now, 10% doesn't sound like much of a variation, but what it actually means for processors of iron ore (they turn it to steel), is there is a three-times difference in impurities between 55% grade and 65% grade. The high level of impurities really means these days, smelters have to use much more energy to process the ore and it also results in high levels of emissions.

For a number of years, [the] iron ore price differential between the 55% grade and 65% grade is between 100% and as low as 50%, but [a] very high premium. These are all very technical things, but what it really means is Anglo American has one of the highest purity iron ore products in the world, and they're charging a premium of 50% to 100% for what seems like a commodity.

Rob Campbell (09:54):

Interesting.

Stas Lopata (09:55):

So, there is a level of differentiation that's highly technical, but what it means is they make much more money per ton of product.

Rob Campbell (10:02):

I've never thought of it that way. That's great.

Stas Lopata (10:04):

The other example of differentiation: I met with Kuehne+Nagel. They are a logistics service provider. They help companies like Adidas to get their running shoes from a factory in China to a distribution centre in Eastern Europe to a retail store somewhere in the rest of the world, for example. Kuehne+Nagel is a commodity business. There is very little differentiation. But company-specifically [it] offers a lot of levels of sophistication for the customers. They basically take headaches off the transportation of goods for some of the largest global manufacturers. Kuehne+Nagel has been doing it for more than 130 years. There's just another company that's been doing the same thing for a very long time, and they're getting better and better.

During COVID, one of the examples of differentiation playing out for Kuehne+Nagel is they've become number one logistics provider for air freight. During COVID, it was very difficult to ship things because of the bottlenecks in transportation because of very high costs. So Kuehne+Nagel was able to gain significant market share during very difficult times because that's when differentiation [in] service matters, and that's when they were able to show the real value of their premium service.

And then one other example is—you probably don't know, and I didn't know either until recently— [when] talking to [the] CEO of Kuehne+Nagel, he said that they had a helping hand in helping the world to deal with COVID. How so? We all know that the COVID vaccine developers really helped the world to get through the crisis, but Kuehne+Nagel was the majority shipper for vaccines from day one.

What happened was, the vaccine developers came to Kuehne+Nagel a few months before the actual vaccine was approved, and they had to set up a very difficult logistical system around the world to ship hundreds of millions of these vaccines in very difficult environments. Some of the vaccines required -70 degrees Celsius, [a] freezing temperature. So how do you ship that? The pharmaceutical companies came to Kuehne+Nagel, said, "Look, this is a challenge. Can you solve this?" And Kuehne+Nagel did. They were able to ship the majority of vaccines around the world for the last two years.

It just shows you the level of sophistication that they have and how customers come to them in advance and ask them to solve their logistical problems for them. As a result, Kuehne+Nagel—in terms of profitability per unit of goods shipped— has one of the highest margins. It's a highly profitable business, and it shows up in the financials as well.

Rob Campbell (12:47):

And like you said, [a] good example of differentiation in what on the surface might appear to be a fairly commoditized industry.

I do want to ask, just on the theme of commodities and your earlier comments on cost of living—so, specifically energy. "Crisis" might be the appropriate word to describe the energy backdrop today facing Europe, especially with winter at our doorstep. What are companies doing, and how are consumers dealing with that?

Stas Lopata (13:11):

Definitely [the] energy crisis is a challenge for countries in Europe, companies, and consumers. What I'm seeing is there is an active adjustment process underway.

Governments have stepped up, and I think that's evident in conversation. When I talk to people, they feel like [the] people in charge are doing a lot of things right during this crisis.

For example, Germany recently built a liquified natural gas importing facility in record time—in under 200 days. These things take years to build. They were able to do it in a record time, and I think they're looking to bring in five more facilities like that next year. [These are] just massive projects, multi-billion dollar investments. But I think governments have recognized that they have no choice, they have to adapt, and they're doing what they can.

At the same time on the supply side of gas in Europe, the United States has become the largest liquified natural gas exporter in the world in record time, and large part of that is going to the UK and Europe.

So, I think countries have been coming together to resolve this challenge collectively. The other component of energy crisis is how much gas they have on the ground. At this time, we have seen natural gas prices actually coming down in recent months. The reason is I think there is an understanding that the crisis might not be as difficult as people thought a couple of months ago, because when you look at the natural gas storage capacity around Europe, it's basically at 100% as of last week [Note: this episode was recorded December 15, 2022]. In Germany, Italy, France, [and] the UK they have quite a bit of gas sitting ready for winter. It's still a challenge and the energy prices are high for consumers and companies, but I think there is a sense that Europe will get through winter in terms of energy consumption.

Now, it's expensive, but they don't foresee interruptions in flow of energy, they don't think that factories will have to close, companies will have to stop production. I think Europe is in a pretty good position for winter. That's the consensus that I'm gathering from talking to many companies. And then next year, there would be other ways to fill up capacity, to continue to expand [the] delivery of different energy sources.

Rob Campbell (15:38):

That's quite reassuring with respect to the near term, but I'm just wondering longer term. You mentioned Germany because they are, at least in my view, really at the nexus of the conversation, especially given the policy decisions that they've made over the past 20 years where, at least in simple terms as I understand it, they basically bet on globalization, outsourcing. I think I read this in the Financial Times: outsourcing their security to the U.S., their growth to export-led growth to China, but then their energy needs to Russia.

So, what's the longer-term outlook with respect to German manufacturing, the German economy, perhaps Europe at large? Just in terms of competitiveness going forward, would you see companies based there moving production to other parts of the world? And how might that influence the longer-term prospects associated with the energy?

Stas Lopata (16:24):

Rob, yes, I agree with the observations. I think COVID and the energy crisis have accelerated long-term transitions. So, as I noted about differentiation versus cost competition, for Europe, it's very hard to compete on the manufacturing of commodities. And what we've seen—BASF is a very large chemicals manufacturer. They've announced couple of weeks ago that they have no choice but to shift their production to other countries. It is a massive undertaking. One of their plants is actually an entire town with its own infrastructure, its own fire hall servicing this huge plant of chemicals. And they're looking to shift this abroad because on [a] cost basis, [it's] not competitive. It's a challenge for Europe.

For our investments, our philosophy and process has been such that we invest in businesses that are much more nimble, [that] typically don't have such high capital requirements, and also we tend to stay away from businesses that compete on costs and produce commodities. And certainly, ones that are located in Europe, they need to adjust. And this will be very expensive. A lot of the businesses we're in are much more flexible. Think about a lab operator like Intertek; they do testing of chemicals as well as consumer goods.

Software operators that we have across Europe…these are businesses that are experiencing other challenges. A lot of the software developers had people on the ground in Ukraine, for example, and they have to adjust to accommodate their employees moving to somewhere else and readjusting their development process. But I think it's much easier to move a team rather than move an entire production plant.

So yes, definitely a challenge for Europe. Specifics are, they depend on individual companies.

Rob Campbell (18:20):

It sounds like it's a perhaps not the companies that we're invested in today, but both your description of what Europe needs to do with respect to its energy infrastructure and the investment required there—as well as if some of these companies like BASF are having a shift to production—the amount of CapEx that might be required for a lot of that…it sounds like there might be an imbalance with respect to the supply and demand for capital.

Is that providing us any opportunities in terms of investment opportunities? Just given the need for such capital investments.

Stas Lopata (18:50):

Capital investments are definitely significant for many years to come for Europe to adjust. We have a number of investments that are facilitating the transition and dealing with the crisis. We own an ownership stake in Iberdrola, a Spanish holding. They're one of the largest installers and operators of wind farms for electricity generation across Europe. We also have two oil and gas producers, Shell and Equinor. They are suppliers of oil and gas to Europe. Shell is one of the largest LNG transportation operators, so they're helping Europe to deal with the immediate crisis in energy.

Stas Lopata (19:29):

All these companies [also as] part of their strategy [have] investments to continue to accommodate the energy transition. Natural gas is still a fossil fuel. For now, it's critical to have. It's better than coal. In the future, even Shell is investing in wind farms. And so I think transition is in the works. It will take many years, and for now, they have to deal with the immediate crisis. But also at the same time, I think both countries and companies are trying to continue to invest so that they continue to transition to greener sources of energy. It's a dual challenge at this time.

Rob Campbell (20:07):

From what I understand at least, perhaps [it's] a step back this year, just given some of the social aspects with countries like Germany—I think they've turned on a number of their coal plants that they previously turned off, if I understand that right.

Can we talk just a little bit more about that, maybe just starting with the social aspects? And I think you mentioned at the outset, there are countries working on this together. What are the power dynamics in Europe between countries, and how does that work?

Stas Lopata (20:30):

One of the most common themes from going to Europe is the need to collaborate. Companies talk about that. Governments talk about that. The way that Europe is set up in terms of energy infrastructure is they share a lot of the flows: electricity, gas, pipelines, electro lines. And what happens is, as long as they all work together, they can manage through it much better. Because when [the] cold comes, it's not uniform across Europe. Some parts of Europe might have colder days, but other[s'] warmer days. And so what happens is, as long as countries are willing to share in the pain and work together, it's much easier for them to send flows where they need it the most.

So, I think the nature of the game at this time is cooperation for all these countries. Companies I think also understand the responsibility as they work with customers and they work with the suppliers. And I think one of the bigger themes is yes, it's a challenge. Yes, they're working through it. And as long as they continue to cooperate collectively, they can get through this together.

Rob Campbell (21:34):

And then going back to your comments about some of the investment opportunities—certainly lots of companies that we own that are directly helping in that regard. But I think for a lot of our clients who might compare our portfolios to broader benchmarks, we're still underexposed to areas like energy, and like you mentioned, tend to still have a preference for many of the asset-light businesses.

What are some of the risks associated with investments in—let's call it energy infrastructure—that seemingly are really needed?

Stas Lopata (22:02):

Yes, there is high demand for capital, but there is also [a] rising level of risk. At this time, governments have to manage the tension between the prices they pay to energy producers and the prices that consumers pay for their electrical bills. And what we've seen just a few months ago [is] some of the countries started to pull away from the agreement that was signed in the 1990s. And that agreement was meant to help companies sue governments if governments defaulted on long-term energy supply contract agreements.

What some of the governments are saying at this time is, "Desperate times call for desperate measures. And yes, there are contracts in place, but we have to do certain sacrifices. We cannot just pass on 100% of energy cost inflation to consumers because that's not sustainable." Governments are looking to make some energy companies pay part of the cost.

It would certainly be considered a subsidy by energy producers. Not a fair one, because they're in the business of making a profit and they need to justify their investments. There are going to be a lot of investments needed, so what companies [are saying] is, "Look, if you start raising taxes, if you start not meeting our long-term 20-year contract obligations, we will invest elsewhere." And I think TotalEnergies just announced that they're going to invest less in North Sea oil production because the UK is looking to raise taxes. It's definitely a challenge.

From an investor perspective, I think what we are seeing is rising risk for energy producers, particularly the ones that are cemented into the ground. If there is a plant that's not movable, it's very easy to target for governments in difficult times. It's very hard for a company to do anything about it. So, we're trying to be very selective in how we approach our investments into energy infrastructure in Europe because yes, it's a challenge; yes, it's an easy target for governments to pursue. And so companies would need to navigate that tension, as well as the governments on the other side.

Rob Campbell (24:09):

Yeah, it's been a real... just the complex interplay between energy sustainability, but then the security and the affordability. Certainly a very complex interplay. On that, I know during your travels in Europe you attended an ESG conference. What did you take away from that?

Stas Lopata (24:25):

I attended an ESG conference in the UK alongside the largest European investment firms. The opportunity was for me to learn how other investment firms think about ESG, their processes in terms of how they make investments, and how they incorporate ESG in[to] their investment process.

One of the learnings is really a macro learning. I think the era of cheap energy, cheap food, and cheap capital is probably over. And that was one of the big themes. How do companies and even governments balance the very rapidly rising cost of all these critical inputs and yet [be] able to continue to make adjustments so that the production of energy, food is sustainable? And I think the theme from the conference is still that there is a resolve to continue to invest and do what's right for the long term while meeting the short-term challenge of the crisis.

Stas Lopata (25:23):

So, I think both companies and regulators continue to move forward in how they adopt and adjust ESG regulation and ESG in their process to manage both the current needs as well as the long-term sustainability needs, particularly in Europe. European regulators also continue to increase requirements for ESG investment disclosure. Companies are very clear about what they do and how they do things in terms of investing.

So, I think when moving forward, there might be some...you could call it a bit of a delay because of the crisis, but I think it might also be a good opportunity to ask the question, "What is actually working within ESG? What is adding value? And how [can] companies set up their processes [so] that there is a clear outcome and benefit?"

There was a lot of talk about greenwashing at the conference, and some of the investment firms thought that a lot of their competitors do things in terms of investment ESG superficially. That's another challenge and a big topic in the investment industry: actual ESG investing versus things to do superficially.

It was a very good opportunity to observe how some of the largest European investment firms think about it. I think the intention is there to continue to make investments, to adjust the process so that large investors continue to exercise their influence on companies in order to increase disclosure, in order to increase engagement, and incentivize companies to make appropriate investments in energy transition and supporting ESG transition.

Rob Campbell (27:09):

Was there anything there that you took away thinking, "Hey, we're doing the right things," or did you find that there were opportunities where you felt that we as an organization could do more on an ESG basis?

Stas Lopata (27:18):

One of the learnings from the conference is to compare our process to some of the largest, most sophisticated European investment firms. One learning is, there is a lot of information about [the] environmental part of the ESG when it comes to emissions from the underlying companies we invest in. Now there are a lot of service providers that aggregate that information—how much Shell generates in emissions versus a software business, and there is a clear distinction and they rank them. So it's easily aggregatable data.

So there is a lot of information in terms of ranking companies on the environmental impact.

At the conference, what I observed is the most difficult question that investors face is the social aspect. There is just no data. Or there is no uniform data that can be aggregated, tabulated, and easily used in a formula. And I think this plays into our own research strength at Mawer, because what we've been doing for years is aggregating unstructured data through [the] scuttlebutt process by talking to employees, individually visiting companies on site, talking to competitors in order to understand the essence of the culture. And [the] social aspect of ESG is really about how companies structure themselves to do the right thing for the employees, as well as continuously and sustainably meet the needs of their customers and be fair to their suppliers and stakeholders as large. That's the social part of ESG.

Stas Lopata (28:49):

And our process has developed over many years to be able to aggregate this unstructured data, data points from multiple places, and then we use that information in our proprietary management evaluation framework in order to understand the culture and rank management teams.

In simple terms, we've been doing it for many years, and we are okay with unstructured data. For large investors elsewhere, it's a challenge. And there are no easily purchasable services to aggregate that. But we do that already, and I think that's one of the strengths of our investment process.

Rob Campbell (29:28):

If I'm understanding you correctly, you're talking about both axes of our matrix. So, both how we incorporate various types of qualitative information on the vertical axis (the quality), but also how that might influence potential scenarios with respect to the discounted cash flow model. Am I understanding that right?

Stas Lopata (29:45):

Definitely. So, the first part is information gathering, and we have processes in place to do that. The next step is to incorporate that into the management framework to evaluate management and rank them across companies. And then of course we take that information to then evaluate opportunities, risks, how [those] play into the value of the company, and certainly plays into the expected return that we think we can generate from the company. So, it relates to both quality, risk, and valuation.

Rob Campbell (30:16):

Thinking of everything that we've talked about today, I wanted to give you the last word: when asked about Europe, are you worried from an investment perspective about the positions that we have?

Stas Lopata (30:25):

European countries are definitely facing a lot of challenges. I think they're working through them. At the individual company level, there is a lot of work taking place to protect the business, to continue to meet their customers' needs in times of crisis.

I think what's important at this time is the level of leadership. And as we would look back on this time, would [we] be able to trace who were the people and companies that stepped up to the challenge and were able to do the right thing in times of crisis? And that's what we are observing at this time, which is who are the companies that are able to meet the challenge and evolve and do even better for customers, exceed their expectations.

Rob Campbell (31:09):

Yeah, and I think one of the things that's going to linger for me after this conversation is just, like you said, the ingrained history with challenges in the past. Which [is] not to minimize what's facing many people in Europe today, but [there's] certainly lots of it in some of the histories of these companies.

Stas, thank you so much for spending some time with us on the podcast. Really appreciate your insights.

Stas Lopata (31:30):

Thank you very much for having me. Always a pleasure.