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The building blocks of the energy transition and the important role of institutional capital

Matt Christ
Portfolio Manager

Nazmeera Moola
Chief Sustainability Officer

There will be no global net zero unless the energy transition in emerging markets is accelerated rapidly. That requires urgent action by the financial community.

Among developing nations, which now account for more than half of total emissions and rising, China alone has available resources to fund its energy transition. The rest of the developing world requires a massive increase in overseas investment. According to the International Energy Agency, roughly US$1 trillion of annual funding is required to decarbonise emerging economies (not including China). As of 2021, less than one-sixth of that sum was being spent.

Less than 1% of the institutional asset pool would be required to meet all of the developing world's net-zero financing needs. The problem is not a shortage of capital *per se*. Global institutional assets, most of which are managed by pension and sovereign-wealth funds, add up to about US$120 trillion.

Many allocators we speak to understand the 'why' but ask how assets can be mobilized to support the energy transition in emerging markets, while also contributing towards their return targets. The first step is for asset owners to recognise that in order to contribute meaningfully to lowering global emissions, they need to shift their allocations – and hence their influence – towards high-emitting companies, industries and countries. To date, too many have sought to clean up their portfolios by doing the opposite. This means allocating to the developing world especially.

13 of the 20 biggest carbon emitters are emerging economies. Large emitters among them include a diverse group classified by the OECD as middle-income countries, such as Brazil, China, Colombia, India, South Africa, Thailand and Turkey. Together, they account for 56% of the greenhouse gases put into the atmosphere each year. Ex-China, they still represent about one-quarter of global emissions. Most of them have fairly sophisticated private sectors and financial systems, offering a broad opportunity set and multiple access points for international capital.

The second step, and perhaps the most important, is to dispel the myth that transition investing in emerging markets is a charitable undertaking. The 'emerging transition' investment universe is large and robust enough – and, crucially, generating sufficient economic value within individual nations – that it offers commercial returns. By sector, most of the transition investment in emerging countries needs to be directed towards building out renewable-energy generation capacity and upgrading the electricity grid. In our view, these and other transition-linked areas of emerging economies can be extremely competitive from a risk-return perspective.

The third step is for pension funds and other large asset owners in advanced economies to become more familiar with the most effective channels for transition investing in emerging markets: corporate

debt and project financing. While many developed-world pension funds currently have an allocation to emerging markets via equities and sovereign debt, very few invest in emerging credit.

Yet this is a deep market, offering a highly efficient pathway to connect institutional asset pools with the businesses and projects at the heart of the emerging world's energy transition. Moreover, by advancing climate-oriented covenants and embedding meaningful carrots and sticks in bond and loan documentation, investors can incentivise progress towards net zero in a targeted and effective way.

Ninety One's emerging markets corporate debt team alone manages investments in more than 40 countries – there are many private- and public-sector entities with serious net-zero intent seeking transition financing. The latter are often running well ahead of the former. In India, for example, whose national climate targets are generally seen as lagging, almost 100 companies have now adopted science-based emissions-reduction targets. In South Africa, Anglo American plans to install up to 4GW of renewable-energy capacity by 2040, which could see the mining giant generate about 7% of its home nation's electricity needs.

In short, the building blocks exist to accelerate the emerging world's energy transition: the capital, via institutional asset pools; the ambition, not least via emerging market companies' transition plans; and the mechanisms, of which the credit markets are arguably the most important. The urgent task now is to connect and action them.

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