Hosking Partners®

ESG and Active Ownership Report

Q3 2022

Foreword

At Hosking Partners, we take an integrated approach to the incorporation of ESG considerations into our investment process. Roman Cassini, Head of ESG, works closely with the investment team to ensure awareness and analysis of all topics which fall under the broader heading of sustainability. This helps ensure that the relevant impact of these issues, both global and local, is taken into account in individual security decisions. We believe this is a better way of addressing the challenge compared with a segregated treatment of ESG issues, and might be described as the opposite of a marketing-led approach. This quarter's report demonstrates that deep integration. In our lead article Roman discusses how the energy transition is shaping macroeconomic developments in different regions of the world, while in our 'A focus on…' section, Chris Beaven considers the role of in-person engagement in assessing investee company management quality.

On the broader engagement front, in early September we were proud to receive formal accreditation as a signatory to the updated UK Stewardship Code. Our signatory document, which details our commitment to the Code's 12 principles, can be found on our website. Furthermore, as part of ensuring an inclusive and equitable approach to everything we do, we have partnered with the charity GAIN (Girls Are INvestors), who place recent graduates into volunteer firms for an internship period. We will welcome our first GAIN intern next Summer.

Please reach out to Roman if you would like to discuss any of the topics raised in this report.

Luke Bridgeman
Partner and Portfolio Manager

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VOTING SUMMARY	Q3	2022
Meetings Voted	64	444
Proposals Voted	534	5,926

ENGAGEMENT SUMMARY	Q3	2022
Targeted ESG	16	51
Total Direct (1-on-1)	52	173
Total Indirect (Group)	33	160
Conferences	16	65

CLIENT NOTICE

This abridged version of the ESG and Active Ownership Report has been edited for public release. If you are a client of Hosking Partners and have not received the full version of this report, please contact us directly.

A Diverse World: Mapping the energy transition

- For many of the worlds' major economies, the energy transition offers both opportunity and threat.
- Different parts of the world benefit from different 'types' of transition – competition over which 'type' succeeds will define the long-term outcome for both planet and population.
- Exciting opportunities are seen in a re-industrialising and largely energy independent North America and a growing India, while front-footed China offers both promise and peril.
- The outlook for Europe is fraught with uncertainty after years of energy policy mismanagement, while some of the 20th century's great petrostates may face a challenging future.

Introduction

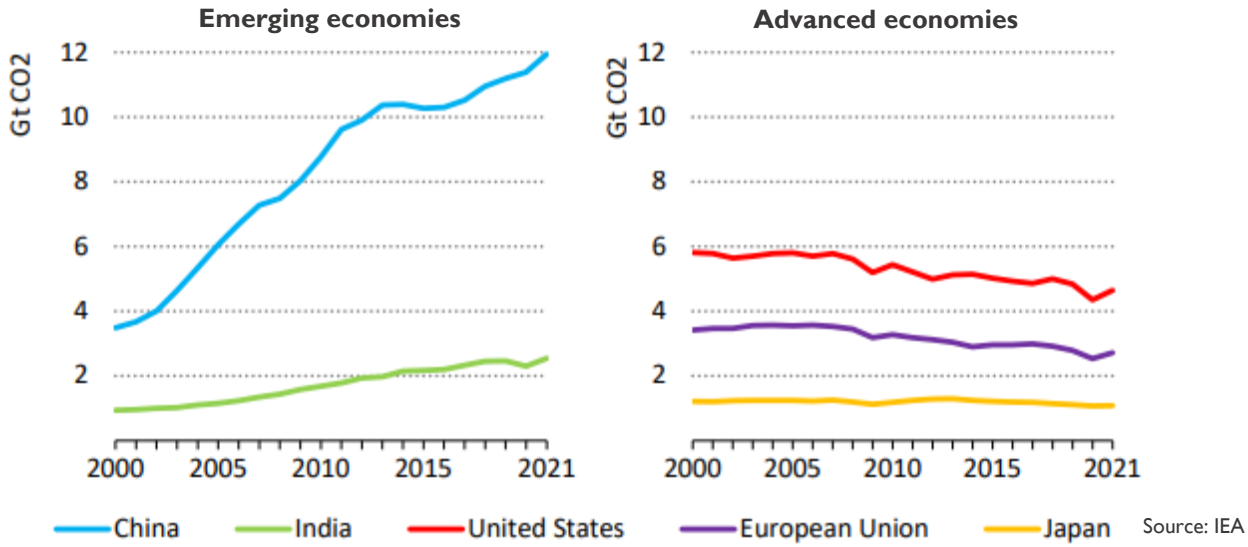
Energy transitions are both systemic and global. The molecular contents of Earth's atmosphere pay little attention to international borders or individual government policies, so it is no use for Europe to decarbonise if China and India's emissions are rising. As the supply mix of energy diversifies, countries that have historically benefitted from fortunate or hard-won hydrocarbon geology may see their advantage diminish as new geologies rich in critical materials gain strategic importance. Meanwhile, to harness the power of global markets to the transition, regulation covering issues such as carbon pricing, sustainable financing, and offsetting will need to be agreed internationally to avoid cross-border arbitrage. Further complicating the picture is the fact that the physical risks of climate change are not equally distributed. Often, the developing countries that are the most exposed to the long-term physical effects of climate change are also vulnerable to the high transitional costs of decarbonisation.

Each of these factors will disproportionately benefit some economies at the expense of others, which hinders international consensus. On the other hand, pressing ahead with domestic net zero policies that are out of sync with the wider world may well prove costly, because on balance these policies remain inflationary over the short to medium term, especially when adopted unevenly. Given that regulatory instruments such as carbon pricing tend to only work anywhere if they work everywhere, managing the differing priorities of the developed and developing world will be essential. Where management fails, conflicts may arise. This piece considers the possible trajectories of several major regions of the world. We start by looking at China and India, where the interaction of growth with energy intensity will shape the global transition pathway. In North America we see the potential for a revitalised manufacturing sector fueled by cheap, decarbonised natural gas. Meanwhile, in Europe, we fear the continuation of two decades of poor policy could dent the region's potential to become a world-leader in renewables. We conclude by highlighting some important risks, and commenting on how the energy transition is already having a dramatic effect on global capital allocation.

The Dragon and the Tiger

The first thing to understand about China and India is that the emissions of these two countries alone define the scale of the global challenge. The entire world currently consumes around 70,000 terawatt hours (TWh) of useful energy per year. Useful energy is the energy that is productively consumed, net of inefficiency losses. Globally, the average efficiency of energy consumption is around 45%, which means we must supply more than twice as much energy as we actually use. The production of that much energy releases 35 billion tons (Gt) of CO2 per year. China alone consumes 20,000 TWh of useful energy, and emits 12 Gt of CO2. This is around a third of the global totals. India is the world's third largest energy consumer, at 5,000 TWh of energy associated with just under 3 Gt of emissions (see Figure 1, next page). In other words, in 2021, these two economies consumed 35% of the world's useful energy and emitted 40% of its CO2. Partly, this is because developed economies in the EU and North America have 'offshored' much of their own energy use

Figure 1: **CO2 emissions in emerging versus advanced economies from 2000 to 2021**



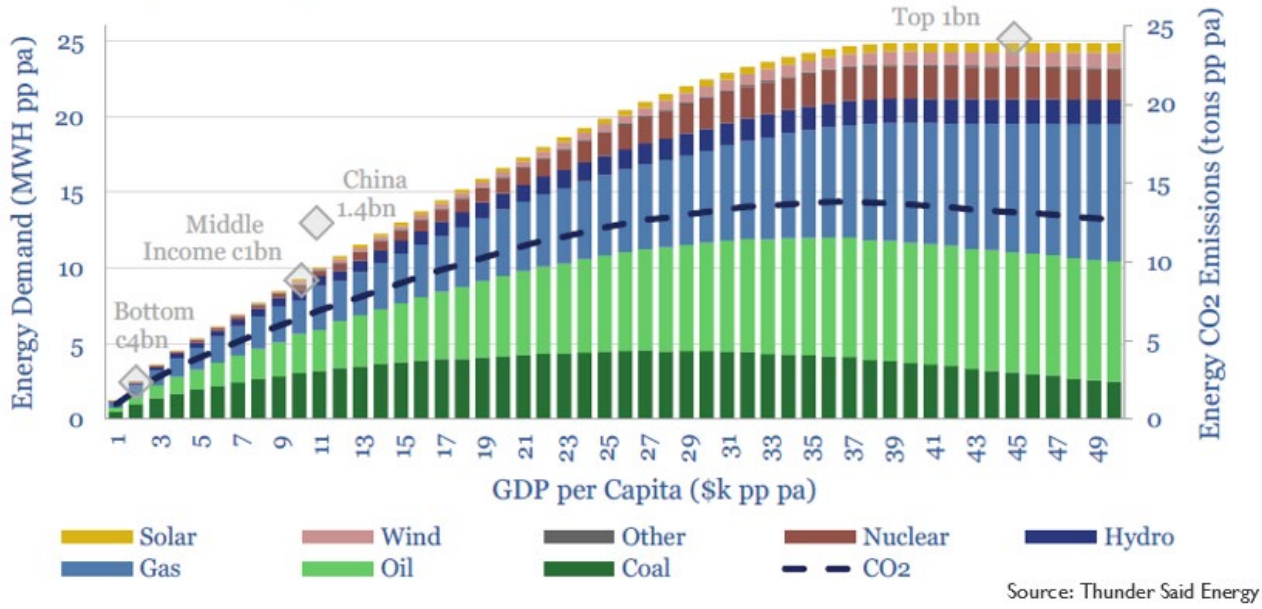
Source: IEA

and emissions along with their industrial supply chains. Nevertheless, the large figures we see today only tell half the story – the real issue lies not in static, cross-sectional comparisons, but in growth rates.

If China and India are to see their GDP/capita continue to grow towards Western levels, then energy demand will rise steeply in tandem. High-income, post-industrial countries are increasingly seeing the correlation between growth in energy use and GDP loosen and even invert. The average energy intensity of GDP growth in the world's richest nations is about zero, and in some cases negative as technology, efficiency, and human capital replaces 'stuff' as the key driver of growth. However, this decoupling has barely begun in China or India (see Figure 2, next page). Adding $1,000 of GDP/capita in China and India still 'costs' about 0.7 megawatt hours (MWh) and 0.6 MWh of additional energy supply per person per year, respectively. Today, Chinese energy consumption per capita is about 2-3x lower than in the West. India's is around 12x lower. Illustratively, were India to have an equivalent per capita energy demand as a basket of high-income countries, it would require around 35,000 TWh of useful energy per year – half the global total. As the world approaches 2050, not only will the populations of these countries continue to increase, but the energy demand per capita will grow. In 2021 China's electricity demand alone grew by an amount equivalent to adding the entire continent of Africa to its grid. Depending on the energy mix employed to feed this growth, emissions will rise somewhere between 25% to 300%. The US and EU combined would need to reach 'Net Zero' twice over to neutralise the annual impact of mid-range (100%) growth in Chinese and Indian emissions. This context is important because it demonstrates that despite a media spotlight on Net Zero in the West, the decarbonisation efforts of high-income countries are essentially little more than a side-show, and involve relatively little threat to growth or quality of life. The success or failure of the energy transition hangs on the actions of the emerging world, and nowhere more so than in China and India, where the interaction of demographics, economic growth, and emissions intensity has potential to derail wider decarbonisation targets.

The energy transition represents an opportunity for both China and India to reduce their reliance on imported energy. At present both countries remain highly reliant on coal, the dirtiest hydrocarbon, which fuels 58% of Chinese and 45% of Indian energy consumption. This compares to 11% in the US and 10% in the EU, as of 2022. The main reasons for this overreliance are firstly that coal is very cheap, at around 1-3¢/kWh, and secondly that vast amounts of it are available domestically. China produces 94% of its coal consumption, and India 80%. This represents a vital strategic benefit of coal, and contrasts sharply with both nations' reliance on imported oil and – to a lesser but growing extent – natural gas. For the Chinese government a reliance on imported energy is seen as a major strategic weakness because the overwhelming majority of it must travel through not one but two narrow and relatively vulnerable maritime straits. These are Hormuz which effectively connects the Persian Gulf to the Indian Ocean, and Malacca which lies between the Indian Ocean to the South China Sea. Meanwhile, in India, the guarantee of Russian oil and gas supply has dictated the government's approach to Putin's war in Ukraine, undermining its aspirations as a progressive, rising democratic power. Coal offers the advantages of low cost and extensive domestic reserves, but the amount of toxic air pollution its combustion causes has become a serious

Figure 2: **Energy use versus income across the world from 1970 to 2020**



Source: Thunder Said Energy

issue – and major negative financial externality – for both countries. Hundreds of thousands of deaths per year are attributed to the toxic effects of the particulate matter emitted by coal combustion, and the smog that hangs over urban areas deters tourism. Furthermore, high population densities leave both countries particularly exposed to the physical risks of climate change, such as flooding, crop yield volatility, and drought. Renewable sources of power are therefore an attractive proposition for both countries, offering clean, domestically produced energy. However, the sheer amount of energy required for their economies to grow means fossil fuels will remain of significant importance to both countries well into the second half of the 21st century. A large part of the journey will be coal-to-gas switching, and both countries have significant untapped domestic natural gas reserves. Efforts to unlock these strategic assets are likely to intensify in coming years.

There are signs that the remarkable pace of growth that China experienced since the early 2000s is slowing. This period was the result of a combination of factors, but chief among them was the relentless expansion of China's industrial export capacity. Fueled by foreign rather than domestic demand, this export boom benefited from the dismantling of tariffs by developed nations. Years of cheap energy, cheap capital, and cheap logistics lubricated the wheels of this symbiotic trade relationship. This effect is visible in the disaggregation of Chinese energy use by sector; a remarkable 60% of Chinese energy demand is industrial, about three times more than the US and 30% higher than the global average. Industrial energy is much harder to decarbonise than residential, commercial or transportation-related energy because it is harder to electrify. At 40% of the Chinese economy, and combined with the reliance on coal, Chinese industry is the reason why China has the highest emissions intensity by unit of GDP in the world. However, the dual shocks of Covid and the Russia-Ukraine war have catalysed a breakdown in the economic relationship between the West and China, with export growth declining from an average of around 25% YoY through the 2000s to just 7% in 2021-22. A Western drive to 're-shore' critical supply chains has begun, partly influenced by an increasing awareness of China's stranglehold on commodities critical to the energy transition such as PV silicon, copper, lithium, aluminium and steel. Concurrently, in China an aging population demanding higher wages and environmental pressures on dirty Chinese coal power are reducing the allure of cheap Chinese supply chains. The pathway forward for China will be significantly influenced by the extent to which the economy can pivot from foreign export-driven to increasingly domestic consumer-led. In the near-term, weakening top-line growth and systemic problems in the real-estate sector are likely to be further compounded by Xi Jinping's regressive political posturing, intensifying authoritarian grip, and concerning military overtures. For investors, the outlook is highly uncertain.

Meanwhile, India's growth story may still lie ahead of us. In the second half of this decade India will overtake China as the most populous nation on Earth. The median age in India is just 28, a full decade younger than China. Over a third of the population are under 20, and although the growth rate is showing early signs of slowing, the UN

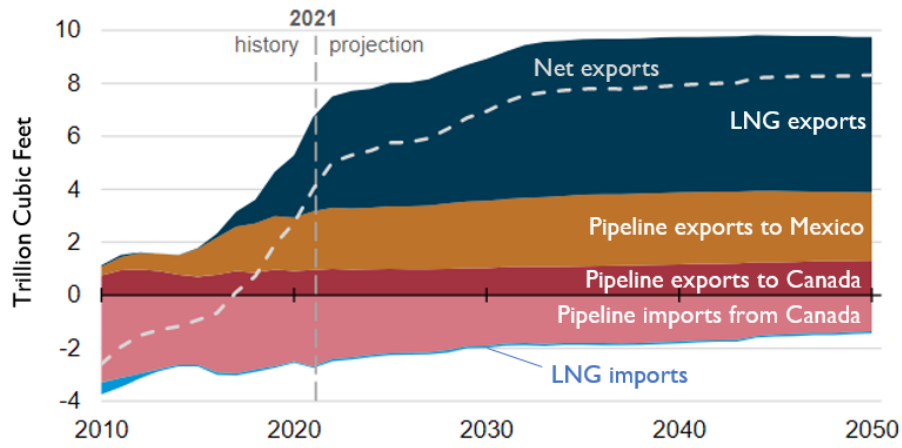
does not expect the population to start shrinking until 2060-70 when it will peak at over 1.6 billion. Despite being the fifth largest economy in the world, India's large population means GDP/capita languishes at just $2,500, less than Congo or Papua New Guinea. Over 300 million Indian citizens live on less than $1.25 per day. This mass poverty means India's energy mix still resembles that of the world's poorest countries, with 20% of demand supplied by biomass. For the Indian government, therefore, the term 'energy transition' means more than decarbonisation. It means doing whatever is necessary to lift hundreds of millions out of poverty, which in turn means massively expanding generation of and reliable access to electricity. It also means guaranteeing that Indian industry is equipped with the energy required to ensure top line economic growth can outpace population growth. The government writes that "energy is the mainstay of the development process of any economy", and they have laid out a strategy to "pursue the transition in [our] own way".

The energy transition could yield significant geopolitical, demographic, and environmental benefits in India, but moving too quickly risks derailing economic growth. India has been upfront about the fact that decarbonisation is a secondary aim after poverty alleviation, which means cost and security of supply will remain a priority in determining India's energy mix. Biomass-for-gas switching is at the heart of India's transition plan, in what is known as the "blue flame revolution". As a result, we can expect India to exhibit increasing demand for both pipeline and liquified natural gas over coming years, and a return to long-term contracting is likely to assure security of supply. Key to India's transition is a dissolution of the multilayered bureaucratic 'license Raj' that still entangles much of India's economy. For energy, this means simplification of the overcomplex subsidy system which encourages the production of low quality, high-polluting coal. More fundamentally, it means relaxing decades of government interference to allow market forces to shape energy supply. India's strategy also means levering the productivity of an increasingly highly educated workforce to drive technological and engineering innovation. Basic Indian literacy rates continue to climb, while growth in enrollment in higher education is expected to accelerate through 2030. Unlike China's primary sector export revolution, the driver of India's 21st century growth may well be its well-educated service sector. This would be a positive outcome for global emissions, because the service sector drives economic growth at a considerably lower carbon intensity than industry. At just 2% penetration of renewables, India's transition remains in its infancy. However, the country seems well-positioned to benefit from growing offshoring of higher complexity white collar jobs, as the West balances reshoring of industrial supply. A young, entrepreneurial, increasingly educated population and a gradually deregulating economy seem an enticing prospect.

The Second Coming of American Industry?

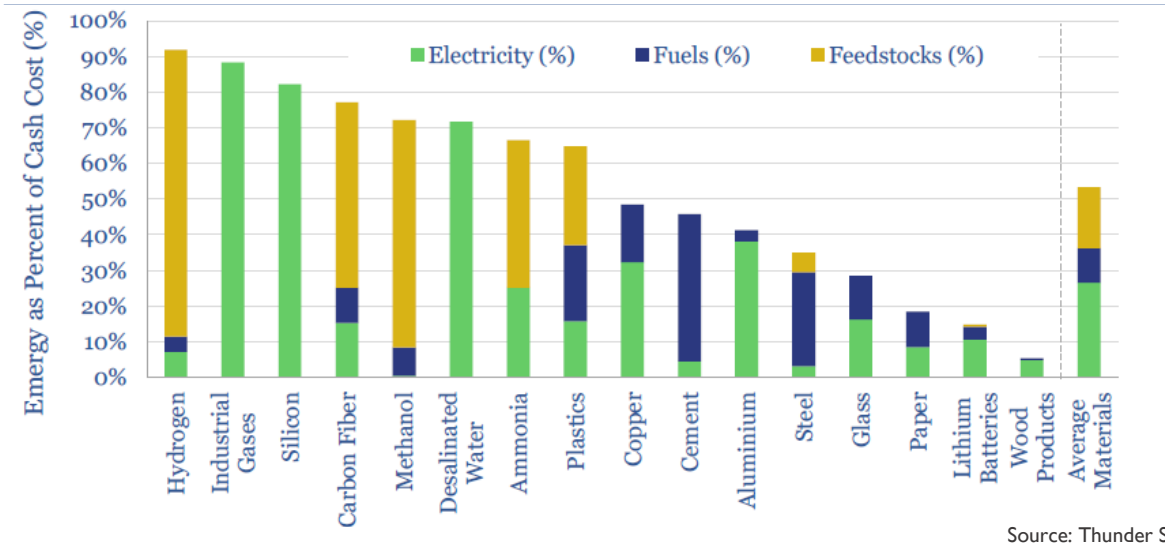
The United States stands out as one of the clearest potential beneficiaries of the energy transition, but the degree of its success is tied to increasingly fractured domestic politics. It is difficult to understate the lasting impact that the US shale revolution will have on world energy, and by extension, geopolitics. Shale oil and gas, thanks to its abundance and short-run drilling cycle not only grants the US the prospect of energy independence but also the critical role of price setter for marginal global supply. In a gradually consolidating oil market, where oil's share of overall energy supply shrinks from 25% to around 17%, the core production base of the approximately 80-85mbpd that are forecast to remain in the mix in 2050 will be determined primarily by operating cost and secondarily by reserve depth. This favours low-cost producers with large installed asset bases such as Saudi Arabia and Qatar, but also US shale which can ramp production up and down quickly to meet marginal demand. This is particularly true for US shale gas, because as the world's renewable generation capacity expands, increasing year-on-year intermittency is likely to increase gas demand

Figure 3: **US natural gas trade 2010-2050**



Source: EIA

Figure 4: **Energy is 50% of the cash cost of the average material**



Source: Thunder Said Energy

volatility. Furthermore, because shale wells are built quickly, ramp quickly, decline quickly, and repay their capex quickly, their cost basis is particularly resilient to rising interest rates. With pragmatic regulatory support, the US LNG export industry could see considerable growth in coming years as other parts of the world attempt to phase out coal. Existing projects alone double capacity from 11 billion cubic feet per day (bcfd) to over 20 by 2030. The EIA suggests this capacity growth levels off after 2030, (see Figure 3, previous page) but that assumption is built on a forecast global natural gas consumption of 200 trillion cubic feet (tcf) in 2050, which is conservative. Should higher forecasts of over 300 tcf of global consumption materialise – driven primarily by countries like China and India – the US is likely to be the primary beneficiary of such a transition pathway, as capacity expansion rises further to meet global demand.

The US' easy access to cheap shale gas could also prompt an industrial boom as supply chains re-shore from China. The re-shoring of industry, particularly that connected with the production of the materials most critical to the energy transition, is already a headline policy in America via the Inflation Reduction Act. Today, around 90% of the market for some of the energy transition's most critical commodities is located in China. China produces 50% of the world's metals, 60% of its wind turbines, 70% of its solar panels and 80% of its lithium ion batteries. This over-reliance on a potentially unreliable strategic adversary has set alarm bells ringing in Washington, an effect magnified by Russia's invasion of Ukraine. The market justification for this concentration has been remarkably cheap energy prices, because energy makes up around 50% of the average cash cost of commodity production (see Figure 4, above). Chinese commodities have been underwritten by subsidies that ensure a managed coal price of 1¢/kWh. Arguably, one of the only regions in the world that can both compete with these energy costs and provide a stable geopolitical and regulatory environment is the southern United States, where domestic gas could also support energy prices as low as 1¢/kWh, assuming a long-term domestic gas price of below $3/mcf. The growing spread between US and European gas prices reinforces the attractiveness of the US, as Europe's energy intensive industrial sector buckles under the pressure of high gas prices. Even in a dovish geopolitical scenario, the long-term price of Russian gas is $8/mcf and imported US LNG $7-10/mcf, two to three times more than US domestic consumers could expect to pay. If the world is drifting towards an increasingly bipolar or even multipolar model defined by regional spheres of influence, then the US stands to recapture industrial market share for many of the key materials and technologies required for the energy transition. However, to do so, policy makers will need to accept the critical role of US natural gas in fuelling the wider transition, because it represents the only cost-competitive alternative to Chinese coal. Because of the way in which labour, energy, and in the future carbon costs will flow through the value chain, both the energy transition and East-to-West reshoring remain generally inflationary trends in the medium term. Maximising the opportunity presented by US shale gas could reduce this inflationary impact and spark a 21st century American industrial boom.

The US' North American neighbours could also benefit significantly from resurgent US growth and a revitalised industrial sector. Canada and Mexico are both intriguingly positioned heading into the

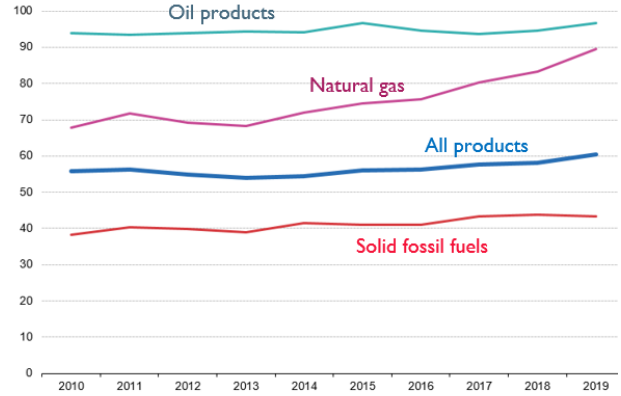
mid to late 2020s. The Canadian oil sands sector – long maligned as carbon intensive and environmentally damaging – is experiencing something of a sustainability renaissance. Alberta oil sands supply about 3.5mbpd (3%) of the world's oil, and they do so at a remarkably low operating cost. Massive reserves, and a mature and cheaply maintained asset base, mean the breakeven cost of Canadian oil has fallen from about $75/bbl to around $45. Concurrently, the Canadian government is carefully regulating the sector to ensure decarbonisation is prioritised, primarily through a creeping carbon price which will rise from $50 today to $170/tonne by 2030. Rather than treat this as a threat, the Canadian oil sands industry is rising to the challenge. The six largest firms – representing 95% of production – have founded the Oil Sands Pathways to Net Zero group, which is dedicated to achieving net zero across the industry by 2050. Canadian oil sands' CO2 intensity per barrel has already fallen to around the global average, and continues to improve. The combination of low operating costs, high cash flows, capital discipline, and well-regulated sustainable targets represent an attractive proposition.

Meanwhile, south of the US border, Mexico could stand to benefit from the US' re-shoring trend. With much cheaper labour costs than the US but an advantageous proximity to Texas' shale basins, we could see some manufacturers elect to cross the border into Mexico. A protectionist interpretation of this concern fueled Donald Trump's aggressive foreign policy towards Mexico, but a more pragmatic approach may reveal more upside than downside. A closer trade relationship with Mexico founded on the flow of cheap gas southward and – in return – cheap manufactured goods northward would benefit both economies, and offset some of the cost impact of reduced access to the Chinese workforce. Surely it would be preferable for America to partner with its neighbour and political ally than continue to depend on a long-term strategic adversary? Regulatory ambiguity and the continued effects of the failed war on drugs weigh on Mexican valuations, but we see upside over the medium to long term.

The Precocious Problem Child

The outlook for Europe is particularly hard to perceive. This is partly because of near-term volatility, and partly because Europe is perhaps the most sensitive region to the 'type' of energy transition that materialises globally. Europe has several productive hydrocarbon resources, most prominently Norway's offshore Troll and Johann Sverdrup fields, but a large portion of its remaining basins are unconventional and onshore. High population density combined with widespread political opposition means exploiting these resources is challenging. As a result, much of Europe has historically

Figure 5: **EU energy dependency rate**



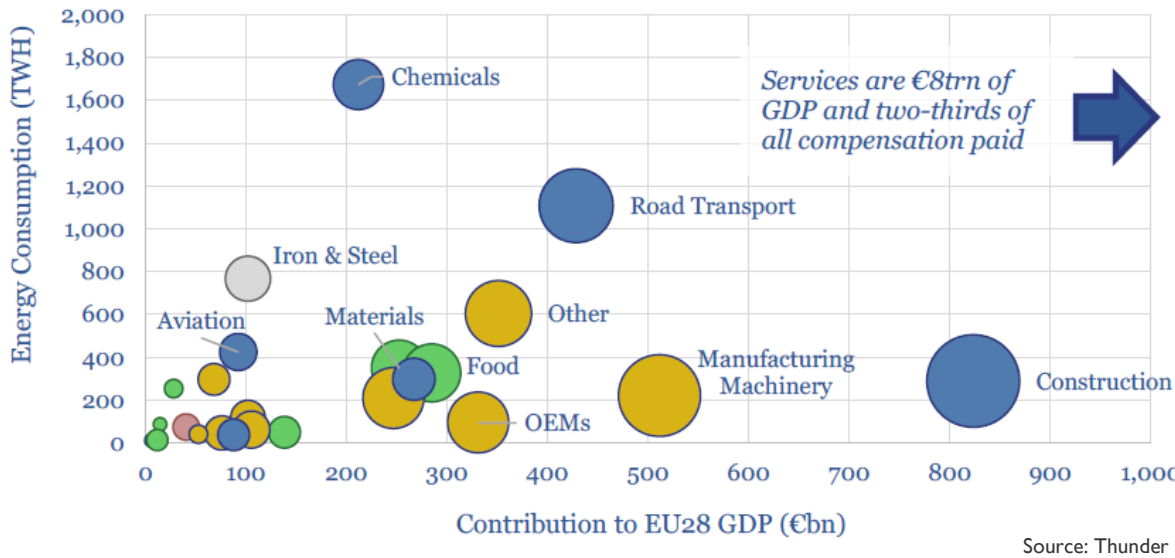
Source: Eurostat

been reliant on domestic coal combined with oil and gas imports from the Middle East, America, and most notably Russia. Eagerness to transition to renewable energy sources has led European investment in upstream oil and gas to collapse from over $50bn in 2014 to less than $20bn in 2022. Although investment in renewables has grown, it has not grown nearly fast enough to displace the reduction in hydrocarbon output, primarily because – as we have discussed before – for every $1 divested from upstream conventional energy $25 must be invested in renewables to add the same amount of energy to the system. Europe's enthusiasm for renewables in the early 2000s was driven by a belief that 'peak oil' would lead to ever-higher fossil fuel prices, and that early investment would pay-off down the line in cheaper energy prices and reduced import dependency. The emergence of US shale challenged this orthodoxy and exposed Europe as woefully ahead of the curve. With billions ploughed into inefficient, first-generation renewables and gigawatts of nuclear power decommissioned, the counter-productive result has been an increase in Europe's dependency on imported hydrocarbon energy from 56% in 2010 to over 60% in 2022 (see Figure 5, above). In particular, Europe has increasingly fallen back on Russian pipeline gas while LNG import infrastructure has remained relatively underdeveloped. This has left Europe exposed to the sort of price shocks seen in 2021-22, and with few easy back-up options aside from ramping domestic coal. The prospect of high energy prices for years rather than months looms. This scenario could prove particularly damaging to European industry, especially in sectors with a high energy intensity per unit of GDP added (see Figure 6, next page). In turn, this means Europe is not nearly as well positioned as America to benefit from the reshoring trend described above.

On the other hand, near-term shocks could shift European energy policy towards a more pragmatic footing. While in the near-term Russia's invasion of Ukraine has slowed Europe's energy transition

Figure 6: **European energy consumption by industry versus contribution to EU GDP**

Bubble size denotes compensation paid; colour denotes primary energy source (blue: gas, yellow: electricity, green: oil, grey: coal, pink: biofuels)



Source: Thunder Said Energy

down, it appears to be catalysing a rethink around longer-term strategy. The inclusion of gas and nuclear in the EU's green taxonomy is positive and should facilitate a faster phase-out of coal-fired power. LNG import infrastructure is being fast-tracked and there are early signs of a revival in longer-term contracts which both provide energy security to nation states and de-risk financing of production and export projects in the US and elsewhere. Assuming consumers are willing (and able) to accept higher bills in the near term, Europe could build out a world-leading integrated renewables network. Rising interest rates should prompt a greater focus on value-for-money and disincentivise over-investment in speculative clean energy technologies in favour of more pragmatic decarbonisation solutions including efficiency, substitution, and inter-regional renewable power generation and transmission. There is likely pain on the horizon for firms that have invested heavily in expensive, long duration renewable projects as valuations predicated on low capital costs re-rate. Nevertheless, if Europe can learn from these mistakes and switch tack accordingly then it could find itself delivering low marginal cost renewable energy to consumers ahead of the rest of the world. This possibility is supported by Europe's thriving sustainable tech industry, which remains a world-leader in nature-based carbon capture solutions, sustainable fuels, and next-generation nuclear and renewables. Meanwhile, the European oil majors are pioneering a 'pivot' model which sees increasing amounts of capital allocated away from upstream hydrocarbon production and towards the technologies and services of a post-transition world. This is a gamble that deserves detailed evaluation to parse the probability of success. Overall, early mismanagement of the energy transition has left Europe at a significant near-term disadvantage. In 2018 economist Dieter Helm wrote that "Europe is failing on its three main [energy] objectives. Its energy is expensive, it lacks security, and it is no longer leading on climate change." While Russia-Ukraine appears to have prompted a serious reassessment that could see future upside, political infighting and economic uncertainty remain worrisome.

Tail Risks, Investment Opportunities and Summary

History suggests energy transitions tend to be accompanied by price shocks, geopolitical upheaval, and conflict. Unfortunately, as we discussed last quarter, we may already be seeing the start of this fragmentation in Ukraine. The energy transition heralds a change to the global order, and some countries stand to benefit far more than – and often at the expense of – others. Friction is inevitable. This will be compounded by the physical affects of climate change, which are likely to prompt climatic trends and weather events that could in turn increase migration, poverty, and disease. These effects will be most severely felt in the world's poorest regions. Pulitzer Prize winning energy economist Dan Yergin predicts that as the transition unfolds, "the clash among nations will become sharper, international collaboration more difficult, and borders higher". Most notably, a gradual decline in some of the 20th century's great petrostates seems inevitable. While hydrocarbon producers with the most stable regimes and easily accessible reserves may survive and even thrive, others will fall by the wayside as gross oil demand peaks and

Source: Google Images

begins to fall through the late 2030s and 2040s. The Middle East, which we intend to return to in more detail in a future piece, seems particularly exposed to this risk. The brutal conflicts that have wracked the region for decades seem unlikely to diminish as its most precious asset devalues. Similarly, as OPEC's unifying reliance on oil gives way to a more diverse collection of strategic interests the cartel's already strained coherence may crack. This would prove beneficial for the US, as the existence of the US' long-mooted 'NOPEC' regulation testifies. Meanwhile, competition between the US and China will intensify as the stabilising effect of globalised supply chains is threatened by re-shored production and protectionism. Unfortunately, conflict – of some form – in the South China Sea seems a question of 'when', and not 'if'.

The Hosking Partners portfolio is built bottom-up rather than top-down, and understanding how global trends interact helps calibrate both capital cycle analysis and single stock selection. The trends described in this piece influence a number of investment ideas in the Hosking Partners portfolio. In North America, we have increased our exposure to oil and gas royalty companies in both the Permian Basin and Canada, with examples being **Permian Basin Trust** and **PrairieSky Royalty**. These businesses have very low overheads and so are minimally impacted by cost inflation, which means they enjoy geared exposure to upside from the price of the underlying commodity as well as production expansion. We are also exploring ideas related to industrial reshoring, although the theme probably remains too young for decisive action. Relatedly, in Europe we are already seeing the strain experienced by energy intensive industries, with a number of firms drastically curtailing production. Our underweight European materials has proved prudent, but perhaps a more interesting idea is looking forward to the more benign competitive landscape that could occur following the shake-out. Here, we expect more energy efficient firms with lower exposure to both natural gas and speculative renewables investments to perform well. Firms that primarily utilise high energy return power sources such as hydro may be particularly well-placed (for example, **Alcoa**), an observation that has also informed additions in the nuclear sector (**Cameco** being an example). In China we remain cautious. The Chinese renewables build-out seems likely to continue, and benefits the larger and most technically efficient solar companies. Unpicking the complex supply relationships in the value chain seems key to locating the most promising capital cycles, while consideration of human rights issues is also important both in itself and for identifying associated geopolitical risk. At the global level we have increased exposure to a number of names in LNG shipping and processing. Exceptionally dramatic increases in the price of natural gas, combined with structural undersupply of natural gas shipping and disruption to pipeline networks make LNG shipping companies such as **Flex LNG** and **Golar LNG** very well placed as to exploit the bottleneck in supply of this essential clean fuel.

At Hosking Partners, the evaluation of macro trends like the energy transition informs rather than drives our capital cycle investment philosophy. The early energy transition has been characterised by a remarkable period of capital re-allocation, with capital rapidly deserting conventional energy in favour of fashionable replacements. This re-allocation has overwhelmingly been driven by a focus on perceived demand – often misinformed by well-meaning idealism – rather than required supply. Critically, overall energy output has fallen as the capital intensity of renewables is higher than that of hydrocarbons. This has contributed to an alarming structural undersupply in energy, and prices have risen accordingly. As the price of energy flows through the value chains of every product and commodity in the world, the effects are cascading through the wider market. Differing regulatory, monetary, and geopolitical responses from world governments and vastly differing risk management strategies from corporates are contributing to widespread market inefficiencies. Two decades of artificially low rates and cheap capital are now buckling under the pressure of a reversion towards the mean.

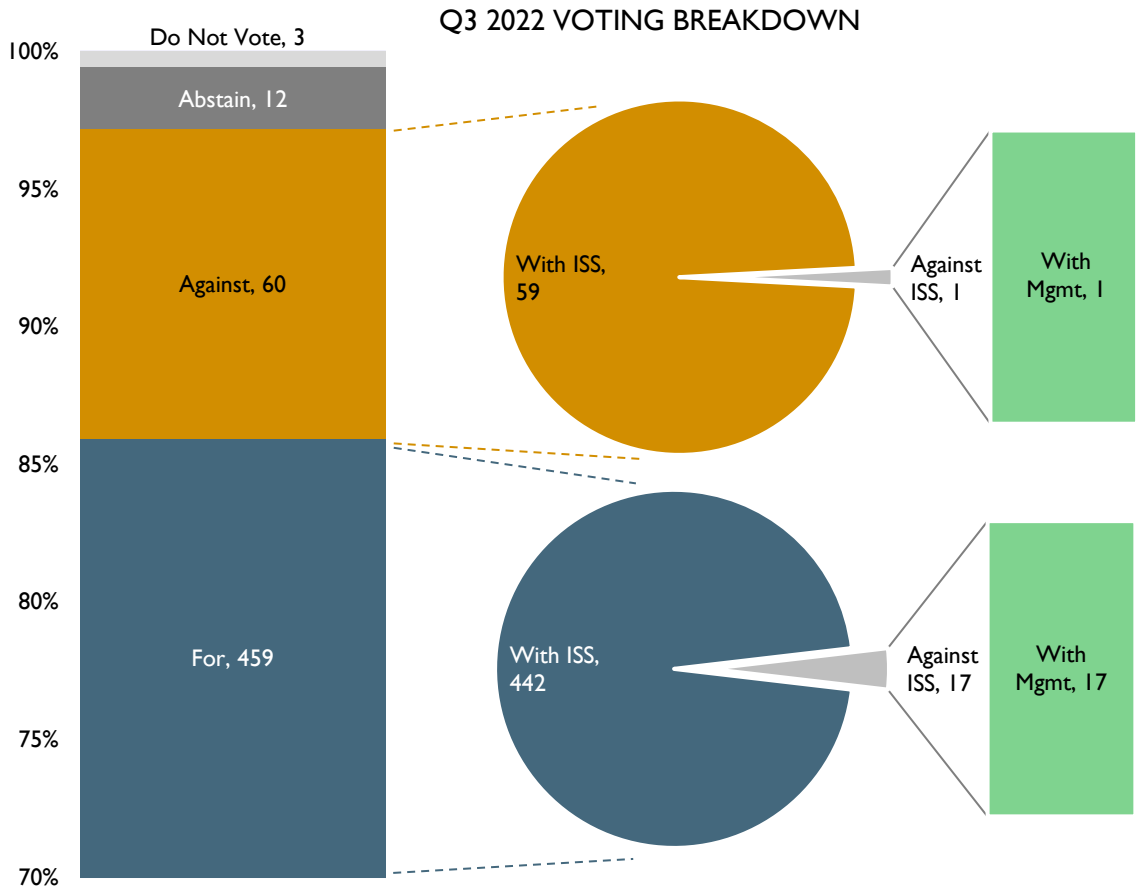
Thinking on and debating the effects of long-term trends is a key part of how we integrate ESG into our investment process, and contributes to our understanding of the likely length and depth of capital cycles around this diverse world.

References & next time

References for any data or quotations included in this report are available on request. In next quarter's ESG and Active Ownership report we will look back on 2022 as well as forward to 2023, and comment on the developments we have observed across ESG themes, including discussion of ESG investing, integration, and regulation.

Voting Summary

Proxy voting is a fundamental part of active ownership and our procedures are designed to ensure we instruct the voting of proxies in line with our long-term investment perspective and client investment objectives. We use the proxy voting research coverage of Institutional Shareholder Services Inc (ISS). Recommendations are provided for review internally, and where the portfolio manager wishes to override the recommendation they give instructions to vote in a manner which they believe is in the best interests of our clients.



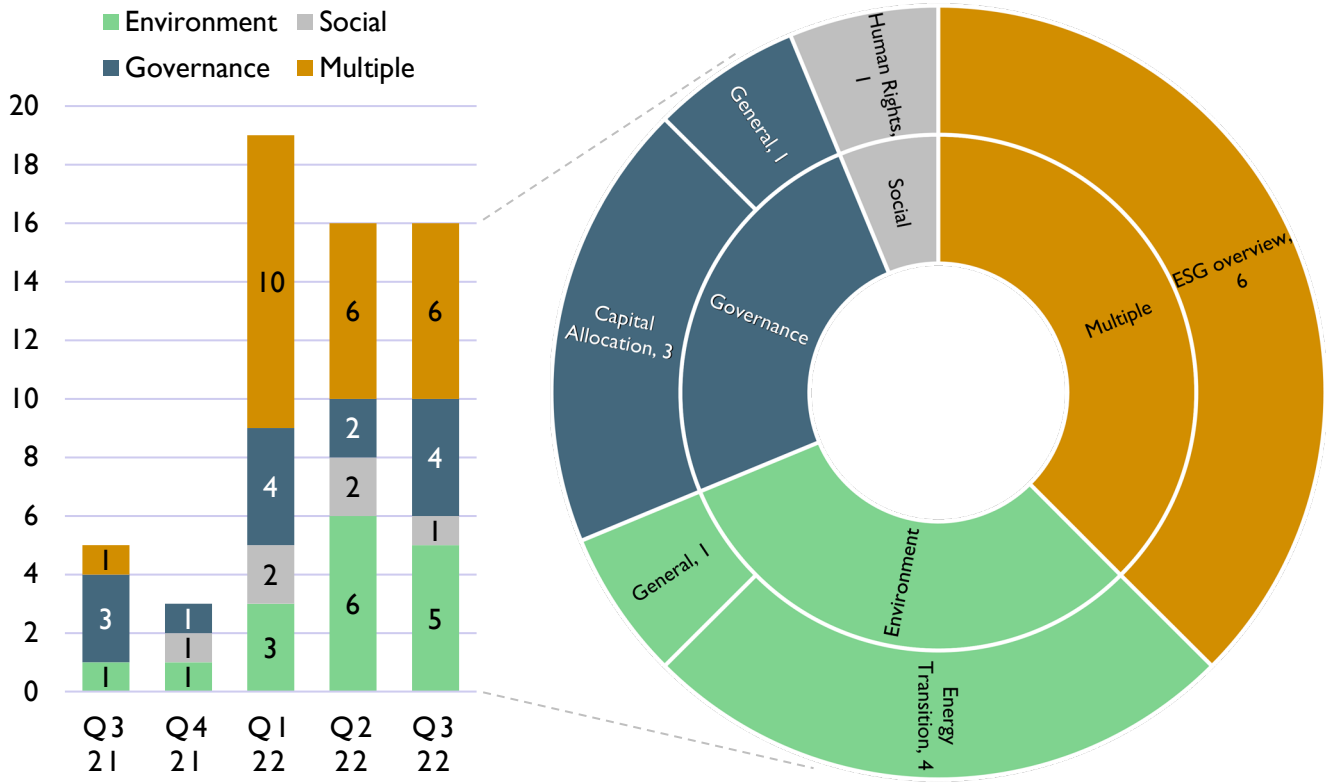
2022 THEMATIC BREAKDOWN	FOR		AGAINST		ABSTAIN		AGAINST ISS	
Director related, elections etc	2,448	48%	177	35%	51	70%	44	33%
Routine/Business	865	17%	24	5%	2	3%	1	1%
Capitalisation incl. share issuances	438	9%	46	9%	-	-	10	8%
Remuneration & Non-Salary Comp	687	13%	89	18%	-	-	19	14%
Reorganisation and Mergers	67	1%	6	1%	1	1%	1	1%
Anti-takeover Related	49	1%	2	<1%	-	-	-	-
Other, incl. wider ESG	597	12%	158	31%	19	26%	57	43%

* Not depicted 36x instructions to 'Withhold', 4x instructions for 'One Year' (advisory vote on pay frequency), and 6x instructions to 'Do Not Vote'

Engagement Summary

Corporate engagement is a core component of Hosking Partners' process. As well as engaging in specific situations, we focus on company management, and careful consideration is undertaken by the portfolio managers to assess whether the management teams' time horizons and incentive frameworks are aligned with the long-term interests of our clients. We also look to confirm management's understanding of capital allocation and believe part of getting capital allocation right is to consider environmental and social risks, along with other factors that might affect a company's long-term valuation.

Q3 2022 ESG ENGAGEMENTS BREAKDOWN



Targeted ESG engagement this quarter remained at a similar level to Q2 amidst a busy conference season. Overall, the number of engagements remains sharply elevated year-on-year. This quarter we conducted sixteen ESG engagements, of which 75% (12/16) were with companies already in the Hosking Partners portfolio, and the remainder were with prospects. More broadly, we had a further 52 1-on-1 company meetings (where ESG issues are a consideration but not the primary focus), one example of which is profiled in the 'A focus on' section of this report (page 12).

The attention on 'Environment' continued, with a number of engagements with oil majors, as well as a deep dive into the portfolio's exposure to Canadian oil sands. We are also in the process of exploring ideas related to Japanese activism as well as reviewing the portfolio's exposure to the shipping sector, both of which attracted engagement attention. These topics will be carried into Q4's engagements, and once further developed will form the topic of a future quarter's Engagement Discussion.

In addition to engagement with corporates, we also conducted a number of important engagements with the wider industry focusing on broader developments in the world of ESG analysis, integration, and regulation. An overview of the trends and developments observed, and a summary of 'the year in ESG', will form the main topic of Q4's headline article.

A focus on… Engagement on the road

- Engaging with companies forms a central part of the Hosking Partners' investment process.
- We are encouraged that in-person engagements at corporate HQ's are finally back on the agenda post-Covid.
- Spending time on-site with management teams can be a powerful tool to enable our team of global generalists with a far longer time horizon than most to join the dots in a complex and uncertain market environment.

Source: Google Images

Introduction

In the third quarter, the Hosking Partners investment team conducted over 100 company interactions, bringing the year-to-date total to near 400. This figure includes both general investment meetings – the majority – and what we consider 'targeted ESG engagements'. In our Active Ownership Report we isolate and report on the latter, aspiring to give clients a window into recent areas of ESG focus. However, with ESG considerations integrated across all aspects of our fundamental investment process, the topics form a part of each and every one of our wider company interactions. After a more than two-year hiatus owing to the global pandemic, this short piece focuses on the importance of company engagement in-person at corporate HQ. These serve both as a tool for enriching investment dialogue, as well as a medium to engage in an impactful manner addressing key governance considerations.

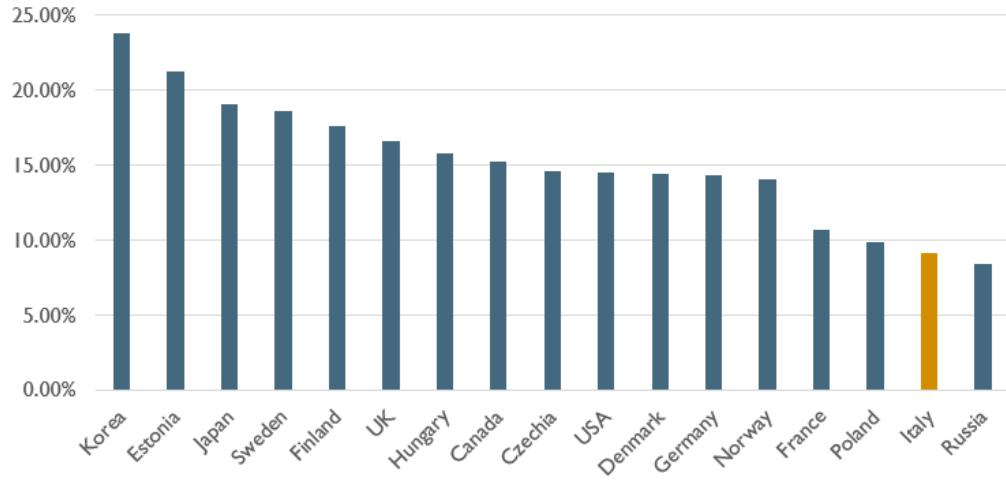
Whether conducted via video call, in-person at our offices, offsite at an industry conference, or out on the road 'treading the leather,' company engagements form a critical part of the HP investment process. Enabling the team to uncover new ideas, build industry or geographic understanding, share perspectives with management as a truly active owner, or to test existing theses, at their core each engagement delivers an opportunity to pursue what psychologist Daniel Kahneman calls 'the outside view'. A great provider of context and perspective, as well as enabling an arguably clearer identification of commonalities where others see only idiosyncrasy, spending time with companies in person – on the ground – has been a particular challenge since March 2020. A recent trip to Milan for two members of our investment team provided a great reminder of the value of such engagement in-person and in the field.

The benefits of long-termism

As a long-term investor applying a supply-side-oriented investment approach, at Hosking Partners we seek out information with shelf life and enabling rich insight. While the deluge of video calls we have all become accustomed to has done much for information overload and perpetuation of the 'inside view,' the opportunity to have in-person, strategic conversations, with a truly long-term investment horizon, is not to be under-estimated. As we have written before, there are numerous advantages to the long-term orientation that we pursue. The opportunity to visit a long-held Italian founder-led investment company, **Tamburi Investment Partners**, sit down in-person with the CEO, and spend time with the senior management at a number of its investee companies provided a unique – yet representative – example of how the team pursues a research agenda in synchrony with the investment process.

Our average Portfolio Manager's turnover is less than 6% year-to-date as we write. At its core this long-term approach empowers us to ask questions that seek out evergreen answers. These are responses that aren't simply valid today, next quarter or indeed this year, but rather have enduring value, grounded in the unit economics of the business, and the fundamental realities of the supply side of the industry. A meeting with one

Figure 1: **Digital sector contribution as a % of GDP**



Source: ResearchGate

Milan-listed industrial company on our trip provided such an insight when they described how the business was able to navigate a slower demand environment through the early Covid lockdowns, before swiftly responding to a ramp-up in orders in the subsequent months with little to no forward visibility. Not evidently apparent from company publications, nor sell-side research, their success was a function of their decentralised and highly entrepreneurial operating model – an approach which has endured for over 40 years – combined with dynamic outsourcing to manage marginal supply needs. These simple but valuable insights not only inform a richer understanding of the business, but also fall outside the scope of the many short-term investors who remain reliant on near-term outcomes, EPS trends, or the latest incremental data point.

Management matters

In a world where most management commentary is prepared, reviewed and rehearsed, the opportunity to spend time on 'company turf' offers particular value to an observant investor. This contrasts with industry conferences, which are dominated by short-term questions du jour, for which most management teams have scripted responses that are carefully designed to assure and even entice. In a 'home environment,' on the other hand, thoughtful questions are more frequently met with considered and sometimes even philosophical answers. Conversations are not simply grounded in the here and now, but rather are appropriately set against historical, and often industry-relative, context to provide real insight into the attributes and character not only of the managers responsible for the running of the business, but the personification of the norms of the company itself. It is this additional layer of understanding that helps us calibrate and judge the real relevance of those material but often intangible factors – often awkwardly lumped together as part of an 'ESG score' – like strong governance, company culture, and strategic risk management.

This personalised, tactile engagement can help us better understand both an industry capital cycle, as well as the extent to which a company's management understands it itself. Spending time touring an apparel store with the CEOs of both a listed retailer and our long-term Italian investment company holding provided great insight not only into the unique, multi-brand strategy being pursued by the former, but also the extent to which both individuals are students of their own industries. Understanding the competitive environment, ongoing capital cycles, and opportunities for industry and brand consolidation are critical considerations for a highly-competitive and multi-channel sector like retail. Equally, in a more nascent part of the market such as digital transformation – which is an area where Italy notably lags other developed economies by digital sector contribution as a % of GDP (see figure 1, above) – it was telling to speak to a veteran CEO of that industry. Our conversations with him revealed two key points, both of which Hosking Partners value as indicators of strong governance. Firstly, he was more focused on ensuring that the business capture the secular opportunity ahead via supplier reach and market position – rather than focusing on near-term demand. Secondly, he stressed the importance of an aligned and incentivised broad management group that is willing to forego a greater share of dollar today to instead share a smaller portion of larger pie over time. Although the Investor Relations teams one encounters over Zoom are often fed

this sort of line to trot out when appropriate, it is simply incomparable to hearing them direct from the horse's mouth while standing in the middle of its paddock.

Capital allocation: be greedy when others are fearful

Warren Buffet provides arguably the simplest reminder of the importance of capital allocation by executive management. He observes that "after ten years on the job, a CEO whose company annually retains earnings equal to 10% of net worth will have been responsible for the deployment of more than 60% of all the capital at work in the business." And yet of course like any market participant management teams have competing pulls on capital and attention. Discussing contemporary share price action of its listed investee companies with the CEO of our long-held Italian holding company, a number of which are down over 30% year-to-date, we were reassured to find refreshing responses oriented in long-termism and contra-cyclical capital allocation. In their role as board representatives we were impressed by the tangible influence of such strong, long-term owners in strategically supporting the allocation of capital towards share repurchases in periods of market aberration, as well as sustaining strategic investment plans, such as consolidation-driven M&A. As with many examples of high-quality boards, such presence and perspective does not only serve to challenge executive management, but also to support and guide the quality of decisions on the table, which over time underpins the compounding of capital for all investors alike.

Now more than ever is a time to focus on getting the basics right, including spending time on-site with company management teams. In a rapidly changing world where old assumptions can no longer be taken for granted, it might appear to tempting to ground research, thought space and engagement with executive management teams in questions pertaining to near-term macroeconomic uncertainty, political gyrations, and the here and now. After all, volatility is opportunity. However, at Hosking Partners with our long-term, capital cycle approach and contrarian spirit we feel now more than ever is about doing the basics right. Our investment team of global generalists, with a far longer time horizon than most and an emphasis on supply rather than demand are well-positioned to identify opportunity through the breadth of their investment aperture. As economies gradually re-open from Covid they find themselves in the midst of a stark new geopolitical milieu. This is accompanied by inflation, a higher cost of capital, the revival of asset-intensive industries, and – broadly speaking – lower share prices. Amidst this brave new world clients should continue to expect the investment team at Hosking Partners to double down on getting the basics right, and to get out on the road, tread the leather, and seek the 'outside view'.

Source: Google Images

Appendix I

VOTING PROCESS

Hosking Partners has subscribed to the 'Implied Consent' service feature under the ISS Agreement to determine when and how ISS executes ballots on behalf of the funds and segregated clients. This service allows ISS to execute ballots on the funds' and segregated clients' behalf in accordance with ISS recommendations. Hosking Partners retains the right to override the vote if it disagrees with the ISS recommendation. In practice, ISS notifies Hosking Partners of upcoming proxy voting and makes available the research material produced by ISS in relation to the proxies. Hosking Partners then decides whether or not to override any of ISS's recommendations. A range of factors are routinely considered in relation to voting, including but not limited to:

- **Board of Directors and Corporate Governance**. E.g. the directors' track records, the issuer's performance, qualifications of directors and the strategic plans of the candidates.
- **Appointment / re-appointment of auditors**. E.g. the independence and standing of the audit firm, which may include a consideration of non-audit services provided by the audit firm and whether there is periodic rotation of auditors after a number of years' service.
- **Management Compensation**. E.g. whether compensation is equity-based and/or aligned to the long-term interests of the issuer's shareholders and levels of disclosure regarding remuneration policies and practices.
- **Takeovers, mergers, corporate restructuring and related issues**. These will be considered on a case by case basis.

In certain circumstances, instructions regarding the exercise of voting rights may not be implemented in full, including where the underlying issuer imposes share blocking restrictions on the securities, the underlying beneficiary has not arranged the appropriate power of attorney documentation, or the relevant custodian or ISS do not process a proxy or provide insufficient notice of a vote. The exercise of voting rights may be constrained by certain country or company specific issues such as voting caps, votes on a show of hands (rather than a poll) and other procedures or requirements under the constitution of the relevant company or applicable law.

The decision as to whether to follow or to override an ISS recommendation or what action to take in respect of other shareholder rights is taken by the individual portfolio manager(s) who hold the position. In circumstances where more than one portfolio manager holds the stock in question, it is feasible, under the multi-counsellor approach, that the portfolio managers may have divergent views on the proxy vote in question and may vote their portion of the total holding differently.

ENGAGEMENT PROCESS

Hosking Partners recognises that ESG considerations are important factors which affect the long-term performance of client portfolios. ESG issues are treated as an integral part of the investment process, alongside other relevant factors, such as strategy, financial risk, capital structure, competitive intensity and capital allocation. The relevance and weighting given to ESG and these other issues depends on the circumstances relevant to the particular investee company and will vary from one investee company to another. Whilst Hosking Partners may consult third-party ESG research, ratings or screens, Hosking Partners does not exclude any geographies, sectors or stocks from its analysis based on ESG profile alone. The multi-counsellor approach, which is deliberately structured so as to give each autonomous portfolio manager the widest possible opportunity set and minimal constraints to making investment decisions, means that ESG issues and other issues relevant to the investment process are evaluated by each portfolio manager separately, with the support of the Head of ESG.

Interaction with management and ongoing monitoring of investee companies is an important element of Hosking Partners' investment process. Hosking Partners does however recognise that its broad portfolio of global companies means that the levels of interaction are necessarily constrained and interaction will generally be directed to those investee companies where Hosking Partners expects such involvement to add the most value. Monitoring includes meeting with senior management of the investee companies, analysing annual reports and financial statements, using independent third party and broker research and attending company meetings and road shows.

Hosking Partners looks to engage with companies generally, and in particular where there is a benefit in communicating its views in order to influence the behaviour or decision-making of management. Engagement will normally be conducted through periodic meetings and calls with company management. It may include further contact with executives, meeting or otherwise communicating with non-executive directors, voting, communicating via the company's advisers, submitting resolutions at general meetings or requisitioning extraordinary general meetings. Hosking Partners may conduct these additional engagements in connection with specific issues or as part of the general, regular contact with companies.

Some engagements highlighted in this publication are part of an ongoing two-way dialogue, and as such Hosking Partners may not always publish the specific details of engaged firms. Where this is the case, further information about the engagements is available to clients upon request.

Appendix II

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