Hosking Partners®

ESG and Active Ownership Report

Q1 2023

Foreword

I am delighted to introduce our first active ownership report for 2023, albeit a difficult quarter for our active equity management. For nearly forty years our fund management team has leaned into (against) prevailing investment orthodoxies. These fads and fetishes have changed over time and in recent years have coalesced around an ESG imperative. Historically it is true that a shareholder focus, care of the environment and sustainability, (all of course tempered by value), have always been hallmarks of successful long-term investment. We believe that today's rigid prevailing orthodoxies will produce a greater mix of risk and return outcomes and challenges for investors than in the past, and reinforce the benefits of a dynamic contrarian approach. I refer you to Roman Cassini's leading article as to how the ESG-era favours those with a capital cycle approach to industry and stock selection.

Our engagement section focuses on a recent trip to Japan conducted by one of our analysts, Chris Beaven. This is a story about how on-the-road engagement has helped open a window into a complex but exciting opportunity, as a cultural and regulatory shift around corporate governance sets the conditions to unlock shareholder value. It's an exciting topic, which has inspired this quarter's cover image as well as an overweight to the region for the first time in forty years.

Finally, analyst Omar Malik takes a deeper look at the Canadian oil sands sector, where we find a (perhaps surprisingly) strong alignment between decarbonisation efforts and long-run performance.

I do hope you enjoy reading the team's thoughts as much as I have.

Jeremy Hosking
Founder

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VOTING SUMMARY	Q1	2023
Meetings Voted	46	46
Proposals Voted	651	651

ENGAGEMENT SUMMARY	Q1	2023
ESG	43	43
Total Direct (1-on-1)	142	142
Total Indirect (Group)	46	46
Conference	23	23

CLIENT NOTICE

This version of the ESG and Active Ownership Report has been edited for public release.

Only dead fish swim with the stream: How our integration of ESG complements the capital cycle approach

Introduction

As we discussed in last quarter's Active Ownership Report, differing interpretations of the role and meaning of 'ESG' is leading to confusion, oversimplification, and even the misallocation of capital. At the heart of the problem lie two different views on what the incorporation of ESG into investment actually means in practice. For some, ESG investing requires a fundamental shift in the way we think about the creation of wealth and value, and accordingly the way asset managers define the fiduciary duty they owe their clients. Under this interpretation, the simple pursuit of financial returns is deemed too narrow a mandate to incentivise investors to contribute proactively to solving the problems caused by negative externalities such as climate change. Instead, asset managers should incorporate supplementary mandates designed to deliver outcomes beyond simply performance. Managers who explicitly design investment approaches in this way are called impact funds.

For others, ESG investing simply means getting better at incorporating consideration of long-term, often intangible and hard-to-quantify value drivers into investment analysis. Under this interpretation, asset managers remain focused on a single mandate – to earn the best risk-adjusted return for their clients – but acknowledge that to do so with requisite care and due diligence demands a holistic approach to valuation that considers a wider range of inputs than merely the basic metrics derived from published financial statements. Key to this interpretation is active ownership, through which a manager levers its shareholding to encourage positive change at an investee company.

Neither interpretation is wrong. But there are fundamental differences in the degree of agency different types of investment have to affect each approach. This is underappreciated and often misunderstood, and has led to the confusion of one type of approach with the other. Increasingly, managers with a focused mandate are being encouraged – by both regulators and the public – to behave and market themselves as if they are an impact fund. Consequently, managers who resist this pressure find themselves at a disadvantage, as do real impact funds whose opportunity set and therefore profit incentive is being squeezed by pretenders.

At Hosking Partners we believe that the manner in which a manager incorporates ESG should emerge organically from its underlying investment philosophy. Without the natural alignment of philosophy, mandate, and process, ESG is doomed to be something peripheral and discrete which can be dialed up or down depending on market sentiment and fashion. Accordingly, the interests of asset owners, investment managers, corporates and governments shift in importance, and the likelihood that capital allocation occurs in the optimal way – whatever that may be – is diminished.

This piece describes how Hosking Partners' approach to ESG complements our capital cycle philosophy. This is a story about how our unconstrained, contrarian style encourages a nuanced and pragmatic approach to ESG which helps rather than hinders our search for opportunity amidst complexity.

> *"To question the obvious and the given is an essential element of the maxim 'de omnibus dubitandum' [All is to be doubted]."*
>
> Christopher Hitchens

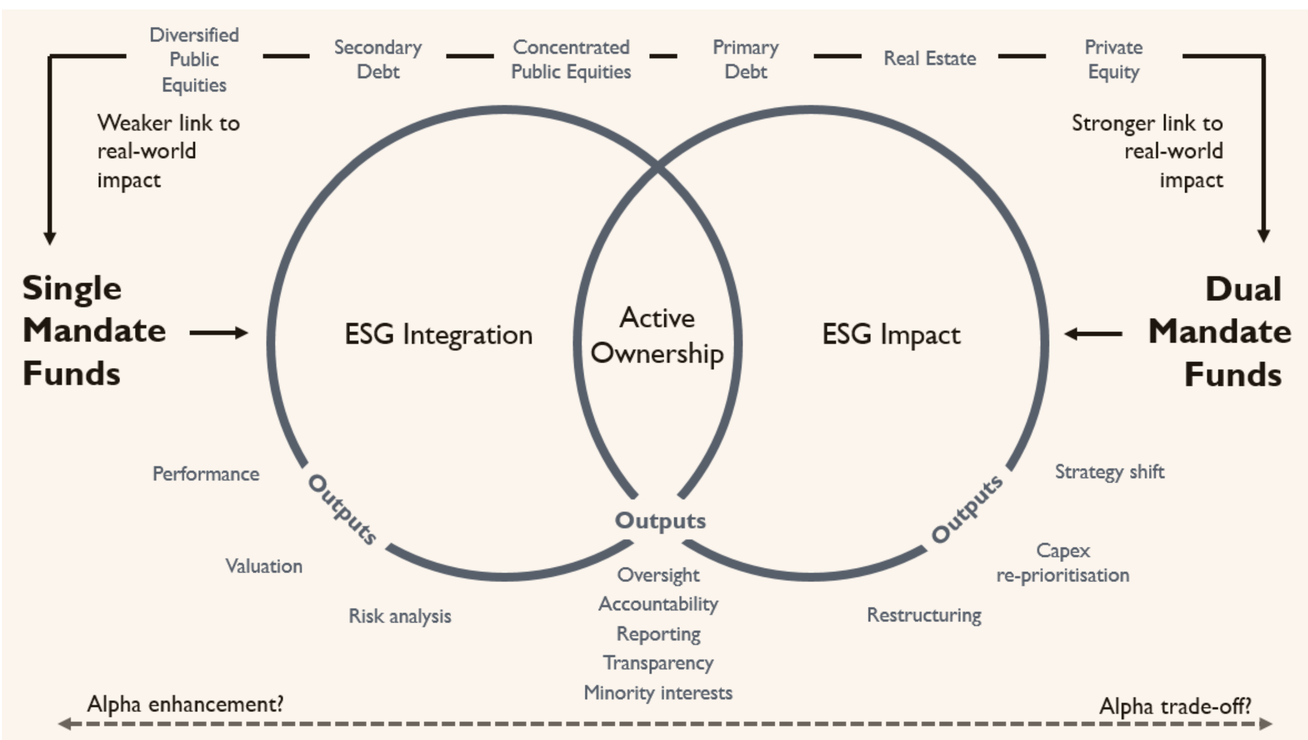
Our people and process

Hosking Partners' investment team consists of four multi-counsellor portfolio managers and three analysts, supported by the Head of ESG. Unlike many of our peers, we are not a collection of specialists with siloed areas of responsibility. Instead, each member of the team is a generalist with an unconstrained global remit. A team member might well find themselves speaking to a Japanese financial services company in the morning before analysing a Chilean copper miner in the afternoon, and the absence of top-down asset allocation means that portfolio construction could be understood as the outcome of an almost infinite number of relative judgments. The key to unlocking this challenge is our capital cycle led investment approach, which applies as readily to one sector or geography as it does to another. The language of the capital cycle helps describe how flows of capital into and out of an industry affect competitive behaviour. Consideration of this provides us with an insight into the future direction of returns on capital, and by extension market pricing or mispricing. This investment approach encourages cross-disciplinary, qualitative, and contrarian thinking. This approach also means we have a naturally long-term mindset, with an average holding period currently over 10 years.

Such an investment ecosystem is predisposed to consider long-term, intangible drivers of value. We are sympathetic to those proponents of ESG investing who claim that companies with sustainable business models are more successful at creating long-term value. In fact, it seems self-evident that those executive teams that are better at managing risk, allocating capital, incorporating fair but dynamic governance regimes, and maintaining a societal license to operate should justify a premium in investors' assessments of the companies they lead, and thus make for better investments. Within the context of the capital cycle, they are more likely to be able to sustain higher returns on capital for longer at the top of the cycle and deliver improvement more quickly at the bottom.

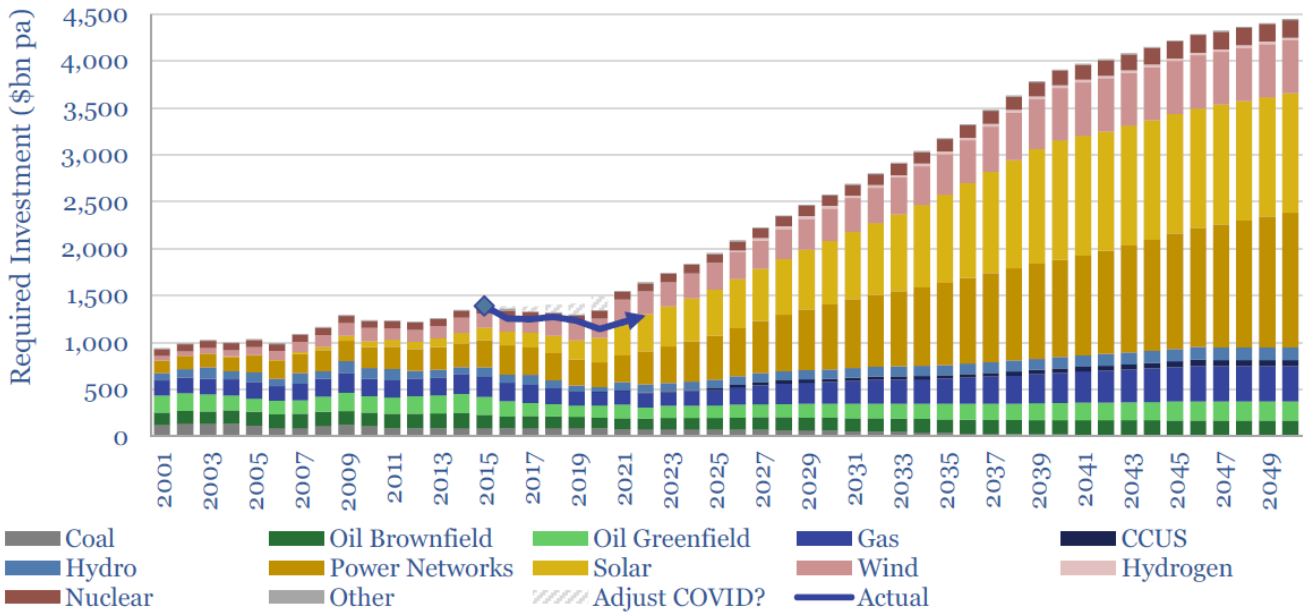
Perhaps more fundamentally, our investment approach makes us predisposed to contrarianism, which provides an interesting overlay to the more conventional ESG integration described above. This contrarianism comes naturally to those who think and speak in the language of the capital cycle, and should enable the avoidance of market groupthink and the asset price bubbles that often result. Recent years have seen oversimplified approaches to complex problems – including the energy transition and ESG – distort the flow of worldwide capital in unusual ways, an effect that has been magnified by a decade of ultra-low interest rates. The result is that at Hosking Partners we have tended to find ourselves on the 'other side' of the consensus ESG trade, as necessary but out-of-favour old economy sectors including energy, materials and industrials are starved of capital and consolidate, just as asset-light growth sectors like IT attract it and incentivise overcapacity. This suggests that the future direction of returns on capital is up in the case of the former and down in the case of the latter. The capital cycle provides us with an approach that both encourages the evaluation of long-term, intangible drivers of valuation, while simultaneously exposing attractive opportunities created

<u>Different ESG approaches, supportive asset classes, and possible outputs</u>



Source: Hosking Partners

Required vs actual investment in primary energy



Source: Thunder Said Energy

by the actions of market participants who adopt a more superficial or short-term perspective.

The tangibility of supply

This 'ESG contrarianism' can be seen most clearly where the withdrawal of primary investment from an industry is mimicked by secondary market participants via divestment. An obvious example is coal. Here, regulatory pressure on financial institutions including banks and insurers has made it increasingly difficult for coal mining companies to secure financing, which raises the cost of capital. Concurrently, secondary market participants, who hear only the voices of declining demand and stranded assets – or sometimes due to simplistic ESG strategies – divest their shares, valuations fall, and the index reweights. The industry responds by cutting capex and consolidating. Readers familiar with the capital cycle lens will know that this set of circumstances is an attractive set-up, as falling levels of invested capital combine with consolidating supply to cause return on capital to increase, and valuations follow. This is not simply the natural oscillation of the business cycle. Rather, pressure is being applied to constrict supply ahead of demand, in the hope that other sources of supply are readily viable, affordable, and available. But this may not be the case, at least in the here and now. In the case of hydrocarbons, the situation is made worse by the material failure to invest enough in potential substitutes such as nuclear, renewables or decarbonised natural gas.

At Hosking Partners, our supply-focused, qualitative, long-term outlook – combined with the wider consideration of ESG issues – lends us the confidence to go against the crowd. In the secondary market, we recognise that the decision to buy or sell shares only indirectly results in real-world impact. In many cases, change may be better marshalled by continuing to hold shares and using the tools of active ownership – voting and engagement – to nudge the company towards decisions that will protect the creation of long-term value. This is particularly the case in industries where supply has been curtailed and capital is scarce. In those circumstances, as the short-term, survival-driven incentive for misbehaviour rises, the long-run rewards for those companies that instead implement the most responsible, long-term strategies grow. The Canadian oil sands producers – discussed in more detail elsewhere in this report – may represent a present-day example of this dynamic. Structurally contrarian, the Hosking Partners portfolio swims against today's current in anticipation of tomorrow's reversion. As such, it is a naturally diversifying bedfellow to allocations to impact funds and sustainable strategies, and should be viewed as their complement rather than adversary.

Prediction is difficult, especially about the future

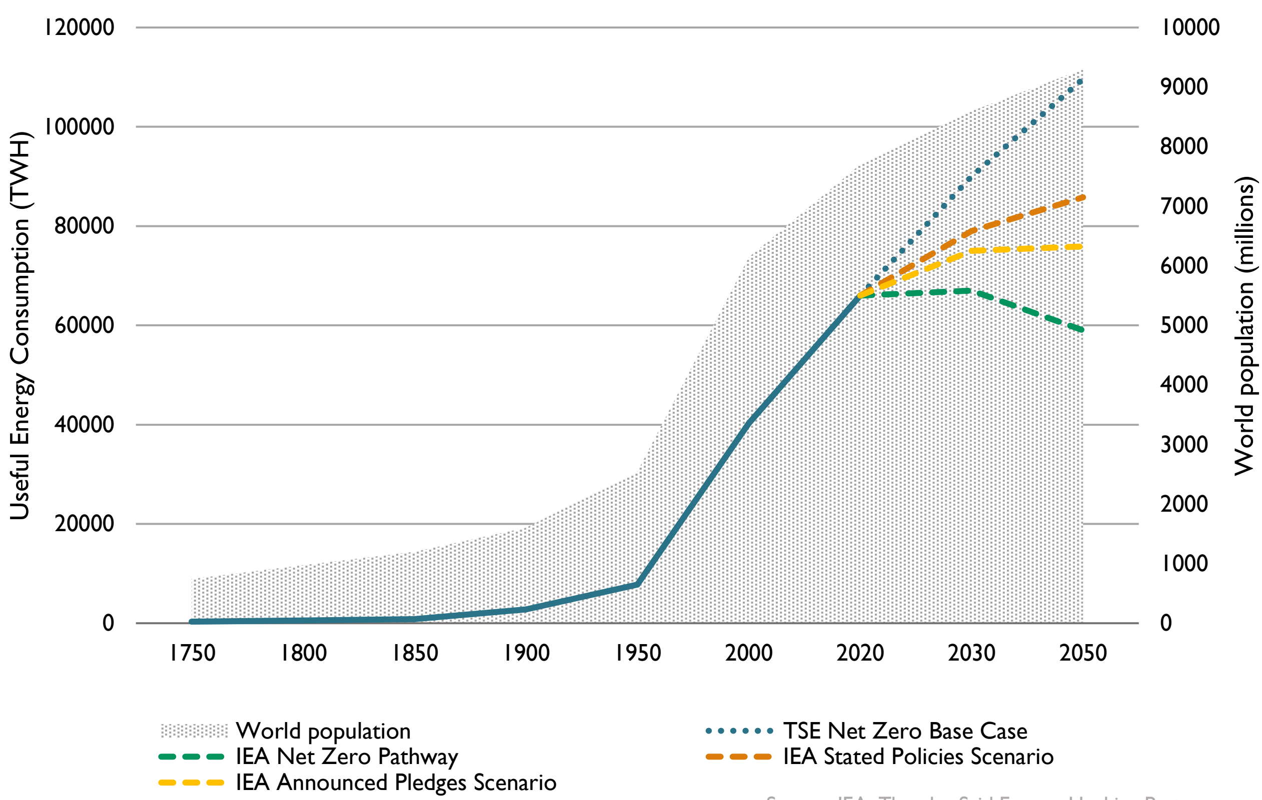
A theme in ESG investing is the idea that portfolio alignment equates to sustainable impact. The idea is that if a manager fills their portfolio with renewable energy stocks, they are supporting the energy transition. We believe this concept is flawed. Nevertheless, selective divestment remains the most popular form of ESG strategy. Why? Part of the answer may be related to the forecasting of demand.

> *"Those who have knowledge, don't predict. Those who predict, don't have knowledge."*
>
> Lao Tzu

As interest rates approached zero over the last decade, future cash flows became an increasingly important component of asset valuations. The lower the discount rate, the more future cashflows inflate the present value of an asset. The further a cashflow in the future, the more speculative its amplitude. While evaluating supply is a somewhat dry affair, forecasting demand is an emotional business. Fundamentally, this is because supply is tangible – but demand is storytelling. A portfolio of growth stocks, which rely on seductive stories about future demand to justify elevated valuations, therefore also tells a bigger story about what its creator thinks the future will look like. When you buy that portfolio, you are buying into that story. You are saying, "I agree with you – I believe in your vision of the future."

Difficulties arise when measures are taken to restrict today's supply to shape tomorrow's demand. Without due consideration of reflexivity, or the second-order consequences of what might happen if there is insufficient appropriate alternative supply to meet stickier-than-expected demand, this sort of engineering invites the risk of shortages and capital misallocation. And yet it is commonplace: If the EU bans the sale of internal combustion engines by 2030, then demand for electric vehicles will be at least X; if green hydrogen becomes the fuel of choice in US passenger cars by 2040, then demand for electrolysers will be Y; if the world is to limit warming to 1.5 degrees, then demand for object A must be at least level B. Here, forecasting is replaced with a sort of fatalism, especially when it is taken in isolation from the realities involved in supplying that demand (capital, time, the laws of physics, and so on). The more 'if… then' statements that are required to justify a demand forecast, the more removed from reality that forecast is likely to be. Examples in the energy transition abound. Exponential demand growth for grossly inefficient and expensive technologies like blue ammonia, green hydrogen, and direct air capture is pitched as inevitable. "If the world stops producing fossil fuels, and if we achieve net zero,

Historical useful energy consumption and various forecasts out to 2050



Source: IEA, Thunder Said Energy, Hosking Partners and if we avoid using offsets to do so, and if, and if, and if…" In an era of near-zero interest rates, today's insurmountable problems can be wished away with assumptions about future technological progress, and speculative revenue that only exists in an unlikely future is reflected in valuations today.

This type of demand fatalism is engineered even by respected international organisations such as the International Energy Agency. As we discussed in 'The Maze to Net Zero', the IEA's proposed pathway to net zero requires global energy demand to fall from today's level by an amount necessary to make its supply numbers work. This 'backsolving' requires an unprecedented breakdown in the correlation between energy usage and prosperity that has been the case for at least the last five hundred years. This is the reverse of the demand fatalism described above. "If demand for oil and gas must be near zero in 2050, then these assets must become stranded, and so valuations must fall". Again, we would question this logic and seize the opportunities it throws up.

Because we want to see the world reach net zero, we are emotionally invested in the stories which describe that outcome being successfully achieved. At Hosking Partners, our supply-side capital cycle approach means we are naturally resistant to both scenario-specific demand stories, and the excessive valuations that emotional crowding encourages. We avoid those areas of the market where we believe capital is being (mis-)allocated against speculative demand forecasts, because we expect lower returns on capital to materialise than the market expects. On the other hand, the emotional dynamics of the energy transition and desire to disassociate from carbon-intensive industries is causing capital underinvestment to run ahead of declines in demand, inviting the sort of supply shortages and consolidation that the capital cycle approach suggests will deliver rich returns for investors over coming years. Our confidence in making these calls is supported by our ongoing study of ESG-related trends, integration of long-term intangibles into our investment analysis, and active ownership of investee companies.

Conclusion

We abide by Charlie Munger's aphorism that investors should try to be consistently not stupid rather than very intelligent. Over-simplistic approaches to ESG – such as the demand-driven alignment strategies described above – have crowded capital into a narrow range of assets whose returns look set to disappoint as the singular future version of the world they rely upon fails to materialise precisely in the manner anticipated. The more concentrated the bet, the greater the risk. In this context, given that even the IPCC questions the likelihood of keeping warming below 1.5 degrees, one must question the wisdom – in risk-reward terms – of bodies such as the Net Zero Asset Manager's Initiative, which requires members to align their portfolios to the emergence of an increasingly unlikely future. Surely effort would be better spent directing capital to impact funds that can actually evidence a secondary mandate? At Hosking Partners, we want to see the energy transition succeed as smoothly and efficiently as possible – but we also recognise that a diversified portfolio should account for the possibility that it does not. In a sad irony, it seems to us that the misallocation of capital driven by ESG oversimplification is working against the transition it claims to facilitate.

The way an asset manager 'does' ESG should naturally complement its investment approach. This should be true both in terms of the philosophy and process that underly that approach. At Hosking Partners, our willingness to invest in unfashionable areas of the market is underwritten by two convictions – both of which are informed by our approach to ESG. First and foremost is the conviction that these ideas will generate long-term outperformance for our clients. Second, that the bottom-up integration of both financial and non-financial analysis helps us discern long-term valuation opportunities that the market misses. Fundamental to both convictions is our capital cycle investment approach, which helps us study companies – and the industries they operate within – in a holistic manner that considers the interaction of financial, behavioural, and systemic factors. As a diversified manager that invests overwhelmingly in secondary equities, we recognise that owning or not owning a particular part of the market may have little real-world impact. And while active ownership and engagement are essential elements of diligent stewardship that we practice on a day-to-day basis, their purpose should always be tied integrally to the creation of value for our clients' benefit. The urge to silo ESG and apply it without thorough, holistic integration should be resisted. In the context of an energy transition that even in the best case will be hugely expensive, we simply cannot afford the misallocation of capital that will result.

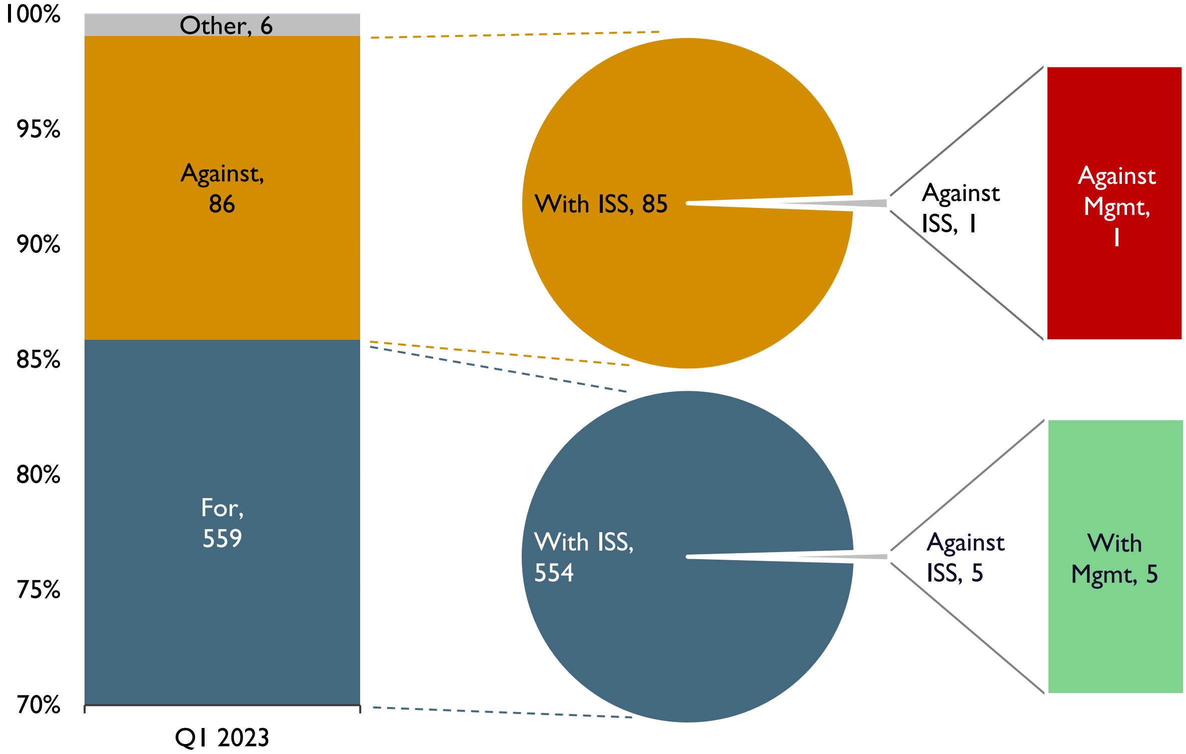
References

References for any data or quotations included in this article and elsewhere in this report are available on request.

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.

Q1 2023 Voting Breakdown



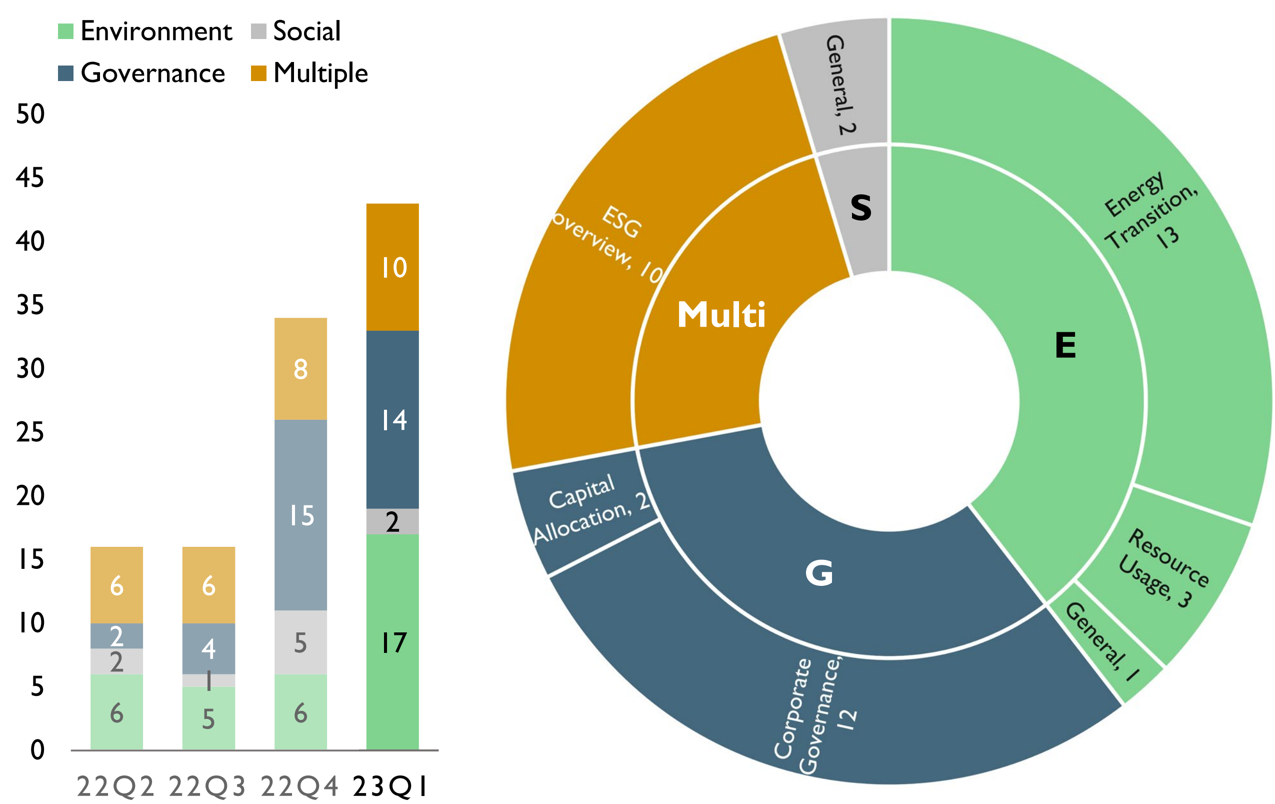
2023 YEAR-TO-DATE THEMATIC BREAKDOWN	FOR		AGAINST		OTHER		AGAINST ISS	
	Total	% share-holder	Total	% share-holder	Total	% share-holder	Total	% share-holder
Director related, elections etc	322	-	47	2%	-	-	2	-
Routine/Business	111	-	9	-	-	-	-	-
Capitalisation incl. share issuances	45	-	4	-	-	-	1	-
Remuneration & Non-Salary Comp	67	-	13	8%	6	-	3	-
Takeover Related	3	-	-	-	-	-	-	-
Environmental, Social, and Corporate Governance	6	17%	2	50%	-	-	-	-
Other	5	-	11	27%	-	-	-	-
Total	**559**	<1%	**86**	<1%	**6**	-	**6**	-

There were no noteworthy votes taken in Q1. The only occasions where the firm voted either against ISS or Management were on minor governance-related issues where we voted in the same manner as in previous years, having already discussed the issues in question with the company. We are happy to share further details with clients upon request.

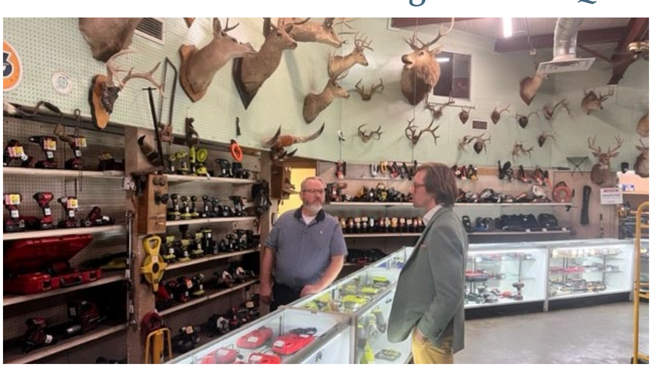
Engagement Summary

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.

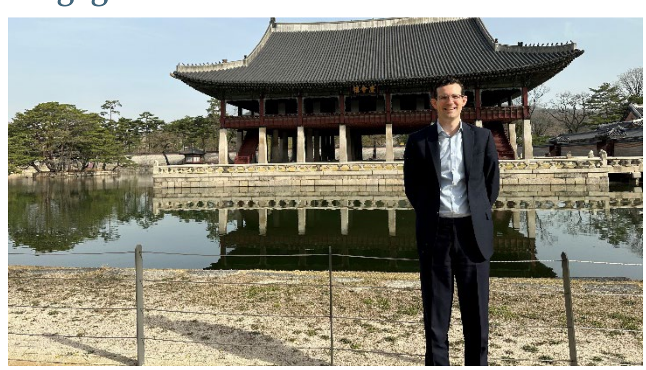
Q1 2023 ESG Engagements Breakdown



Hosking Partners' Q1 2023 Engagement Postcards



Steve Chambers ponders the replacement value of a set of antlers in between visits to oil royalty companies during his research trip to the Southern USA…



…while Chris Beaven wonders what 14th century South Korean monarch King Teoji would make of modern corporate governance codes.

Engagement Discussion

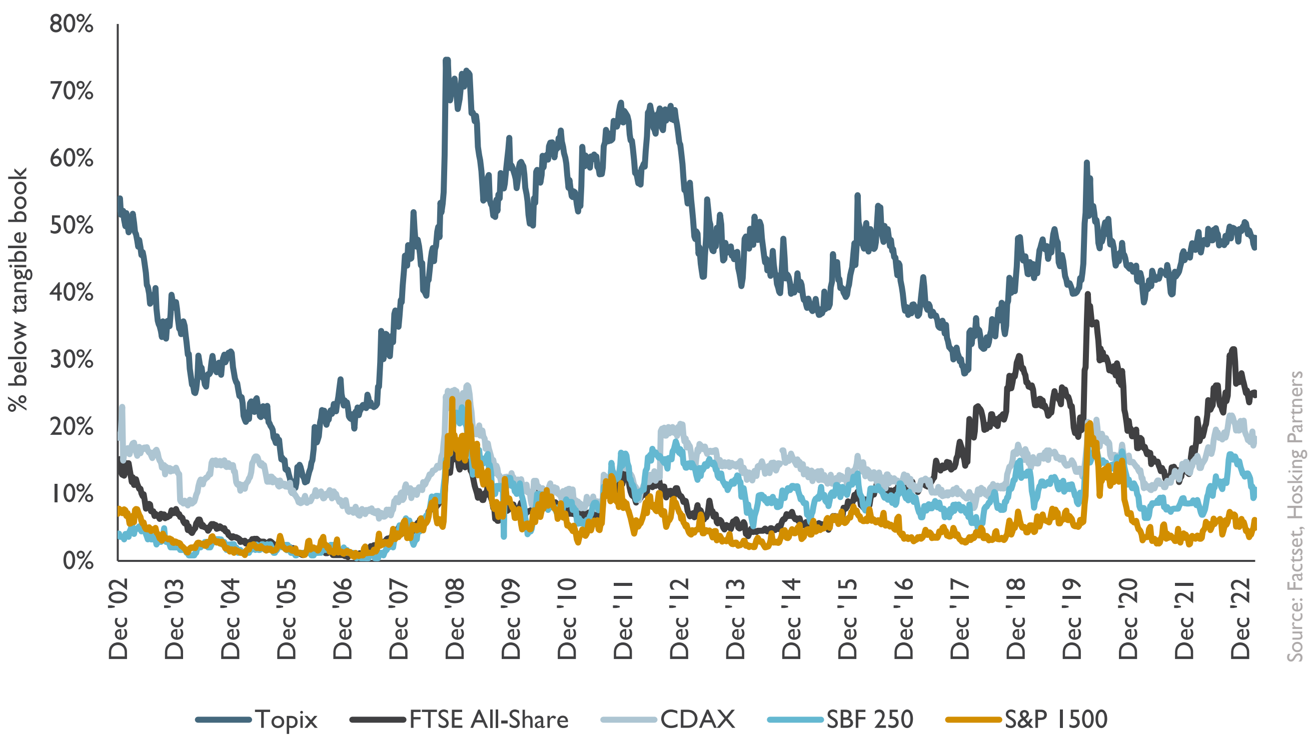
Company	Country	Engagement Type	% of Voting Shares
Japan Engagement Report	Japan	1-on-1 Meetings	Various

2025 will mark 10 years since the Corporate Governance Code was introduced in Japan. Progress to date has been non-linear and inconsistent – arguably echoing the relatively pedestrian equity returns delivered over the period (~4% annualised return for TOPIX since 2015 versus >9% for MSCI ACWI) and helping to explain the fact that over 50% of Japanese listed equities today trade on a valuation below 1x Price/Book (P/B). The relative nascency of Japan's corporate governance movement reflects both cultural nuances, as well as all-too-important economic history. One pertinent example is the close ties between Japan Inc. and the domestic banking sector. Dating back to the immediate aftermath of World War Two, the banks were critical providers of debt capital to corporates following the withdrawal of wartime fiscal earnings. However, many loans were ultimately converted to equity, resulting in Japan's financial institutions becoming meaningful owners of domestic equities. The net result was a requirement for Japan Inc. to pay deference to their new majority shareholders, prioritise debt obligations, and improve financial stability. In retrospect this marked a turning point concurrent with a de-prioritisation of return-seeking minority shareholders. The bursting of Japan's bubble in 1991, the economic impact of the Kobe earthquake in 1995 and the Asia Financial Crisis in 1997 continued the trend towards bolstering balance sheets, encouraging protectionist cross-holdings, and underpinning a conformist conservatism in Japan Inc.'s capital allocation approach. As the Japanese phrase goes, "the nail that sticks up gets hammered down".

Returning to the present day, and hot on the heels of an investment trip to the Land of the Rising Sun, we believe real change is afoot in Japan. Most clearly voiced in a collection of communications issued by the Tokyo Stock Exchange (TSE), we are starting to see very public endorsement of necessary corporate-led reforms to promote concepts such as capital efficiency, returns on capital, and shareholder returns. Indeed, based on on-the-ground engagements with the TSE, more than twenty listed corporates, and Japan-focused investors (both local and overseas), we get the clear sense that for corporate governance in Japan 'this time could well be different.' The road will undoubtedly be long and winding – a nod to the Japanese phenomenon of Ukino, the pursuit of taking a slower course in life – but we are encouraged by the early signals. 2023 is expected to be the third consecutive year of record shareholder returns in Japan (dividends plus share repurchases), as companies start to unload their unwieldy cash-ridden balance sheets and sell down investment portfolios that are distracting from true industrial asset bases. Meanwhile, recently-issued Medium Term Plans across the index have included commitments to a greater focus on returns on capital. A handful of corporates have even announced a desire to achieve a P/B of at least 1x – a symbolic valuation threshold highlighted by the TSE in a number of their communiqués. As we approach the upcoming AGM season for many Japanese corporates, it appears likely that the declining voting support witnessed over the past 2-3 years – a sign of mounting pressure on boards from both domestic and overseas investors – will likely be a feature of the landscape of the journey.

Source: Google Images

Global Indices' percentage of constituents trading below Tangible Book Value



Our engagement at one forestry company's Tokyo offices focused on the ability and inclination of the company to increase reporting transparency related to the value embedded in their large forestry holdings. We were encouraged to hear that this is a matter that management is focused on. This complements their recent announcement to pursue the launch of a forestry fund business leveraging their asset class know-how while deploying third-party capital. A robust reporting framework will be a critical element, which will have a positive read across to the company's own balance sheet holdings. Meanwhile, our engagement with a mortgage insurer focused on the board's recently announced Medium Term Plan (March 2023). We welcomed the company's decision to continue their trend of improving dividend payout distributions (targeting a 50% payout ratio by 2025 from <30% three years ago). However, with the company's achievement of a single A credit rating in February 2023 and limited reason to continue to build reserves, it is likely that future growth will convert into distributable capital at an increasing rate. With the shares trading at a discount to book value, reflecting neither its market leading position nor its strong capital position, we continue to encourage the company to consider increasing shareholder returns further, including opportunistic share repurchases in light of the value we believe is on offer. Lastly, our meeting with a printing firm followed closely on the back of the company's strategic update, including the announcement of a significant share repurchase programme (Y300 billion over three years). While progress in shareholder returns is to be commended, we believe there is significant further value to be unlocked as the company works hard on the capital efficiency of its balance sheet, and we are encouraged to be invested alongside an activist with a c.5% stake.

As global generalists investing in an unconstrained manner, we believe we are well-positioned to identify the opportunity in Japan. With no pre-determined affinity to any particularly geography or region we endeavour to see the wood from the trees and allocate client capital to parts of the market where prospective returns are most compelling. Meanwhile, our highly-diversified portfolio means we are able to able to deploy a basket approach to a market where the headline valuation opportunity is clear for all to see, without simply placing concentrated bets on a handful of companies. Additionally, sidecar investing with a number of thoughtful, long-term engaged and activist investors with whom we share philosophical investment overlap empowers us to take advantage of the opportunity as stewards of client capital to drive meaningful corporate governance improvements.

As of the end of Q1 2023, Japan represented 8.2% of the Hosking Partners portfolio (against 5.5% for the Index).

A focus on… Canadian oil sands

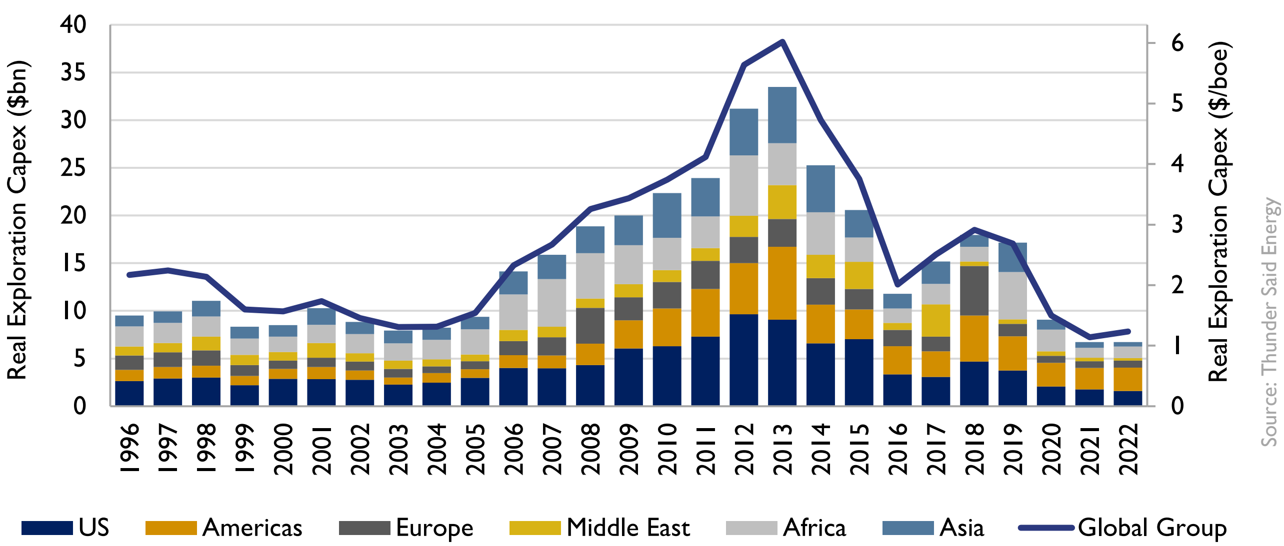
- Oil sands have a bad reputation due to the high carbon intensity of their production process
- However, in a world where new greenfield fossil fuel development is becoming harder and less attractive to finance, Canadian oil sands' huge reserves and low sustaining capital costs offer unexpected advantages
- A robust regulatory environment and clear alignment between meaningful decarbonisation and future returns offers a compelling incentive for real progress

In 2023, all-time high oil demand of 102 mbpd (million barrels per day) represents around 30% of global energy consumption. According to the IEA's Net Zero pathway, oil demand must fall to 72 mbpd in 2030, before declining to just 24 mbpd in 2050. Whilst we believe the transition will take longer than the IEA expects, the direction of travel is clear and ultimately for the good of the planet. This outlook is deterring oil companies from making significant capital investments, a state of affairs sustained since 2016. The 'big five' SuperMajors, which comprise 11% of global oil and gas production, spent $10 on capex for every barrel of oil produced. This compares to an average of $18 in the decade from 2004-2014 when production declined by 1.5% per year. Meanwhile, today's exploration capex of $1 per barrel is at an all-time low in real terms.

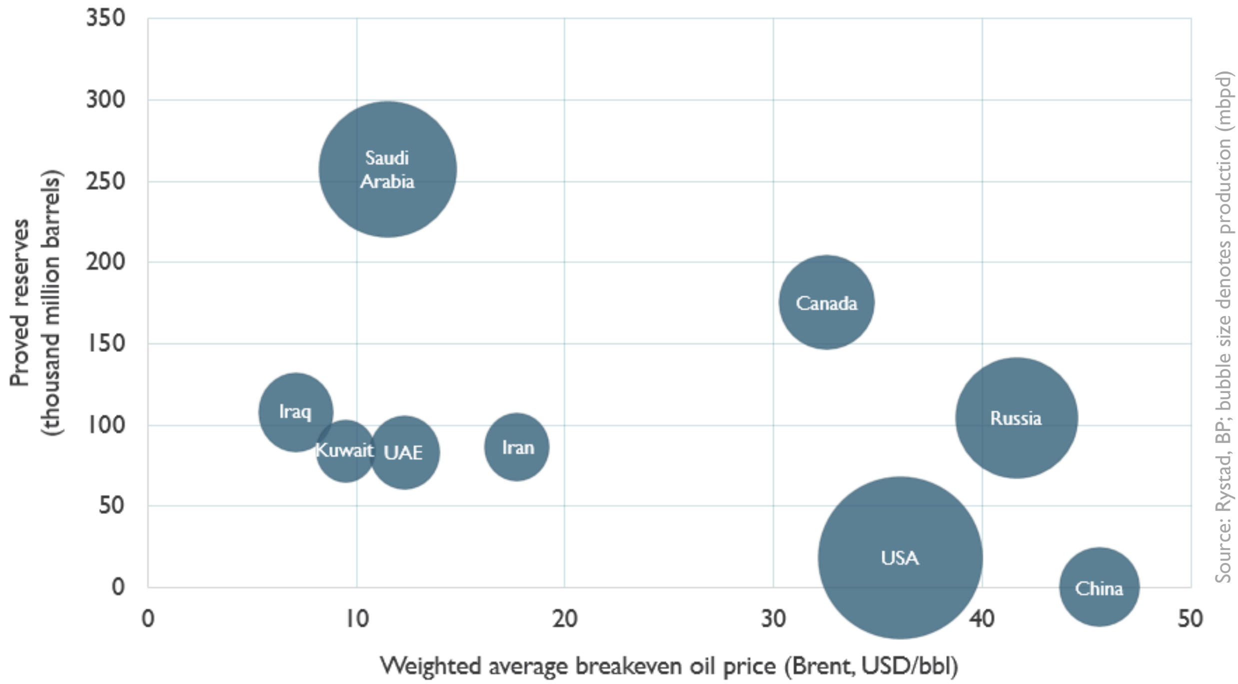
The Canadian oil sands constitute the fourth-largest oil reserve in the world, of around 165 billion barrels. The overwhelming majority of this is found in the province of Alberta across three basins – Athabasca, Peace River and Cold Lake. Oil sands are a loose sand deposit which contains a very viscous form of petroleum known as bitumen. When bitumen is deposited at shallow depths, it can be surface mined. However, about 80% of Alberta's recoverable bitumen reserves are buried too deep to mine and can only be recovered by drilling wells. This is referred to as "in situ" recovery. The Hosking Partners portfolio has holdings in three of the six largest operators (by both market cap and reserve depth) across the Canadian oil sands.

Global energy consumption on a per capita basis can be expected to grow by around 1% annually over the next three decades. Estimates of this figure vary considerably, but around 1% represents a reasonable average that is in line with the long-term rate of 1.2% from 1990 to the present day. Due to the energy- and capital-intensive nature of the energy transition, sources of oil that require relatively low levels of capital to sustain production are becoming increasingly important, because

Real oil exploration capex over time



Global oil reserves by weighted average breakeven price



they allow more development capex to divert to renewables without deepening overall energy shortages.

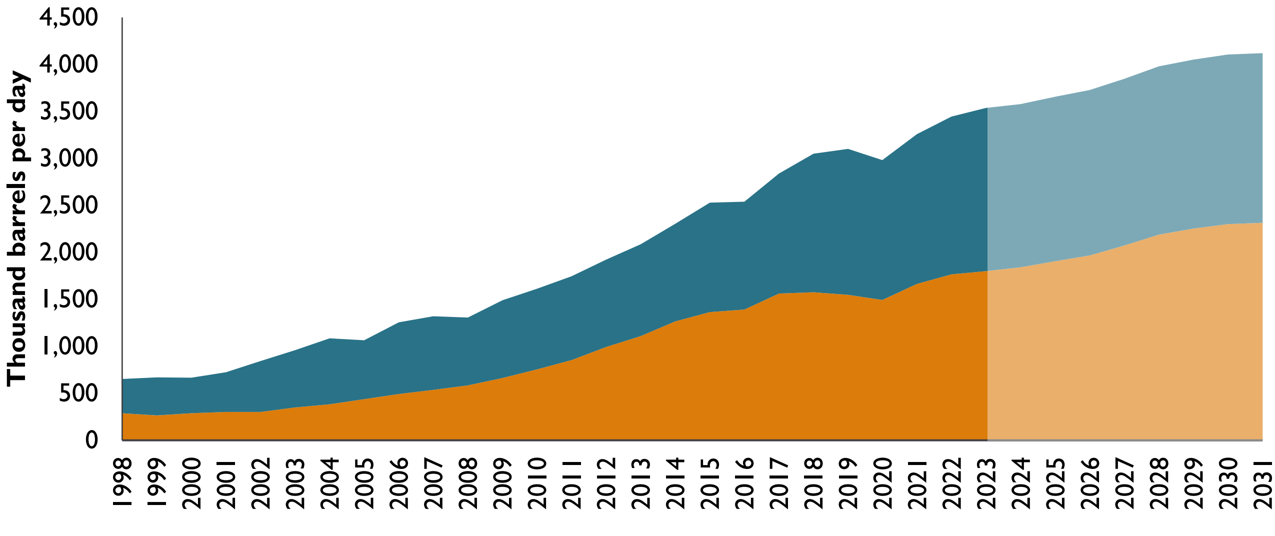
In this context, the unique cost structure of Canadian oil sands makes them a particularly attractive resource. Oil sands projects require substantial up-front capital investment. However, once these investments are in place the assets are able to maintain and even slightly grow production year after year for decades, with a relatively low marginal cost per barrel. This is a function of the geology of the deposits and the methods of extraction, which results in a low decline rate of just 5-10% per year. The outcome an extremely long asset life and zero exploration risk. This is in sharp contrast to US shale oil, which is less costly to start up, but where decline rates can be up to 40% per year per well. This results in shorter reserve lives and greater reliance on treadmill-like exploration activity to sustain production.

The high cost of production commonly quoted for oil sands includes capex costs for the development of greenfield sites that are unlikely to be built. The Alberta Energy regulator estimates the minimum dollar oil price needed to recover all capital expenditures, operating costs, royalties, taxes and earn a specified return on investment is $73-82 for a new mine and $43-51 for an in-situ site, which is expensive by industry standards. However, in reality long lead times (>10 years), large upfront capex (~$10bn), the lack of shareholder support, and burdensome permitting means major greenfield projects are simply not viable in today's environment. Indeed, the operators we have spoken to say we are unlikely ever to see another large oil sand mine developed in Canada.

Given capital investment is now sunk, operators will continue producing as long as the prevailing price is above the marginal cost of an additional barrel. Oil sands' operating costs have improved dramatically over the last 20 years and now sit at around $20 per barrel at some of the largest sites. While it is true that US shale producers still have an operating cost advantage, ranging between $10-15 per barrel, when you factor in the higher capital costs required to sustain shale production, the significance of the gap becomes less meaningful. For example, two of the largest Canadian operators can sustain their current production by spending $4-8 per barrel per year, more than 50% less than average US shale operator, who needs to spend between $10-15. Furthermore, the majority of the Canadian players have lowered their cash breakeven to around $35, which is on par with the most efficient US players. Importantly, this includes capex to sustain current production as well as covering the dividend. Moreover, the low marginal cost of expansion projects at existing sites means that Canadian oil sands production is expected to increase by ~600,000 b/d by 2030. More than four-fifths of the growth is expected to come from the ramp-up, optimization and completion of projects where capital has already been invested.

But what about emissions? Due to the energy intensity of the production process, oil sands are higher

Canadian oil sands production over time



Source: Alberta Energy Regulator

carbon intensity than conventional oil sources. In-situ sites use super-heated steam to reduce the viscosity of the bitumen and allow it to be extracted. Furthermore, most mined bitumen requires the added step of upgrading to break down the heavy hydrocarbons into lighter components which can be transported by pipeline and sold as synthetic crude oil. Both of these steps consume considerable amounts of energy, which generates CO_2 emissions. While CO_2 intensity has fallen by 21% since 2009, emissions nevertheless remain above global averages. As the world moves towards Net Zero, the most carbon intensive barrels of oil are at risk of curtailment, especially if carbon pricing becomes commonplace. This reasoning continues to weigh on oil sands valuations, despite the seemingly attractive financial profile outlined above. However, we believe that the reality of how this unfolds may be more nuanced than it first appears, for several reasons.

Long asset life and a front-loaded capex profile means that Canadian oil sands represent one of the only oil resources in the world that can sustain current levels of production without further development. Several major organisations – most significantly the IEA – have stated that no new oil and gas development can be supported in a Net Zero scenario. Perhaps counter-intuitively, in that scenario Canadian oil sands may emerge as a potential winner. Less exposed to the consequences of ever harder-to-access bank financing – required elsewhere simply to sustain production – the oil sands producers can quietly continue supplying oil markets, even as the overall size of oil's portion of the global energy pie gradually shrinks. The runway here is measured in decades rather than years, and the minimal development capex needed means more cashflow can be returned to shareholders throughout.

Despite high carbon intensity at time of writing, Canadian oil sands are perhaps uniquely positioned to be able to deliver meaningful emissions reductions over coming years. Recognising the requirement to maintain a long-term regulatory and social license to operate, the six leading Canadian oil sands producers have joined forces in the first collaborative basin-wide decarbonisation initiative in the world. Termed the Pathways Alliance, this is targeting net zero Scope 1 and 2 emissions – i.e. those emissions generated as part of the production process and as a consequence of associated electricity demand – by 2050.

This Pathways Alliance aims to reduce oil sands emissions in three phases. The first phase sees the construction of the largest carbon capture and storage network in the world. It will capture CO_2 from more than 20 oil sands facilities and move it via a 400km pipeline to an underground storage hub. This will reduce CO_2 emissions by a third by 2030 and is expected to cost C$16.5 billion, the majority of the C$24.1 billion committed to be spent by the Alliance before 2030. If this reduces emissions by around 20 million tonnes per year as claimed, then it will achieve a carbon abatement cost of around $25 per tonne, assuming a 30-year productive asset life. This compares to carbon abatement costs of around $400 per tonne today for Direct Air Capture projects. The second and third phases will reduce emissions via a mosaic approach encompassing efficiency, offsets, and most notably new solvent and steam-reducing extraction technologies that could lead to significant further reductions in both emissions and operating costs.

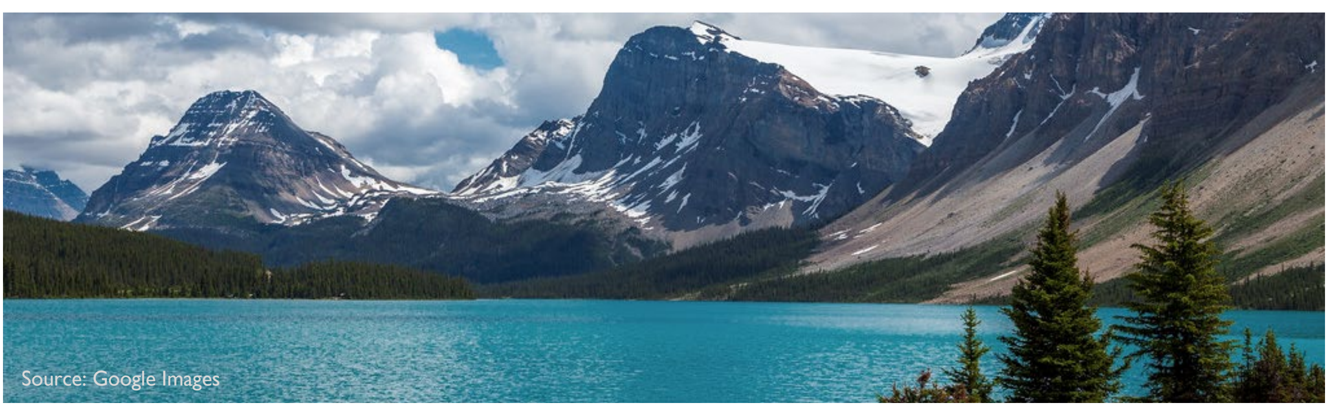
Canadian oil sands production is concentrated in just six operators that account for around 95% of production. This makes coordination of this complex carbon capture project easier. Indeed, the CEOs of the six operators conduct a weekly call to personally monitor and discuss progress of the Pathways Alliance. Furthermore, all of the assets of the major players are concentrated in Canada's fourth largest province, Alberta, with the total deposit occupying just 140,000km^2 of land with the major processing facilities even more tightly situated. This relative proximity – by contrast the Permian Basin in the US alone occupies over 220,000km^2 – combined with the low decline rate of the assets, supports the economics of large carbon capture facilities, and allows a single pipeline to serve all six operators. This is in stark contrast to conventional oil companies that operate thousands of well heads, diversified across different basins and geographies, who continually need to drill new wells, with obvious consequences in terms of the amount of emissions-controlling equipment required, and its operating cost if it is being constantly redeployed.

Meanwhile the Canadian government has committed to supporting the project to meet its own emissions commitments. In March 2022, the Canadian government unveiled its new climate change plan to reduce greenhouse gas (GHG) emissions by 40% below 2005 levels by 2030 and achieve net-zero emissions by 2050. This includes reducing emissions from the oil and gas sector – which account for 27% of the country's emissions – by 42%. The government has already announced a generous investment tax credit for 50% of carbon capture project costs until at least 2030 to accelerate investment, and the companies expect there is more to come.

Furthermore, Canadian oil sands offer critical geopolitical stability. In a world where OPEC+ is as much a political actor as an economic one, where conflict routinely disrupts energy flows, and where regional spheres of influence are an ever-increasing reality, Canada has slowly but surely delivered the world's most consistent oil production growth over the past 20 years (as depicted in the production chart on the previous page). The main alternatives for new oil sands production are found in geopolitically volatile countries such as Russia and Venezuela, so Canada's geographic and political stability seems a major positive as the West and its allies prioritise energy security and diversify their imports away from strategic adversaries.

For us as investors, the transparent and well-regulated nature of the Canadian oil sands producers means we can track progress towards decarbonisation targets and – through active ownership – hold management to account if they fail to deliver. The same cannot be said for all oil producers. Indeed, the large majority (80%) of the world's proven oil reserves are owned or controlled by national governments who may be non-democratic and therefore unaccountable. Of the 3.2 billion remaining barrels – which are accessible for private sector investment – 52% are found in Canada's oil sands.

Canadian oil sands therefore represent a relatively unusual example of an industry where financial and ESG considerations are clearly and relatively unambiguously aligned. Because the significant up-front investment required to reduce emissions is more attractive if associated asset lives are in the 30 to 50 year range, in oil sands the goal of decarbonisation is aligned with the long-run operating runway. Compare this to the incentives for a shale operator to maximize short-term cash flows given the well often runs dry after a few years. If the Canadian oil sands producers want to continue to be a viable source of oil as the federal minimum carbon tax rises from C$50 today to C$170 in 2030, then successful decarbonisation becomes very material to future margins. Combined with attractive fundamentals, geopolitical stability, and regulatory support, we believe that even the most cautious ESG-focused investors should give Canadian oil sands a second look.



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.

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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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