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Environmental Investments

Ambienta Sustainability Lens

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The Impact of the Green Deal and Recovery Fund on Sustainability Investments in Europe

Political and public support for climate in Europe has never been stronger. Environmental sustainability has become a key cornerstone of the political agenda of the European Commission (EC) for the next 5 years. The urgency to act is shared by both politicians and citizens in Europe, as the awareness of climate change and the need to act quickly to achieve the Paris agreement targets has increased in recent years.

The following analysis highlights the initiatives undertaken by the EU to support the European project and kickstart a more sustainable economy. Their preliminary findings show that, although the necessary political compromises watered down the initial proposal, an embryonic fiscal integration and common funding programme were laid out. In addition, a clear focus towards green investments was enshrined in the agreements.

Historic Recap of the EU's 2030 Climate Targets

The first European climate targets for 2030 were agreed to in 2014 and upgraded in 2018 (*2030 Climate & Energy Framework*, -40% Greenhouse Gas (GHG) emissions vs 1990). In 2019, two additional steps were taken: The National Energy Climate Plans and the EU Green Deal. With the first, all European Union members agreed to establish country-specific targets to achieve the 2030 climate goals. With the second, the EC adopted the first comprehensive approach to environmental sustainability beyond energy transition, proposing stricter targets for GHG cuts (-50% by 2030) and climate neutrality by 2050.

Finally, in January 2020, the EC presented the EU Green Deal Investment Plan: the EU's commitment to invest € 1 tn in "green investments" over 10 years (2021-2030) to reach the agreed climate goals. This sum will be sourced as follows:
-€ 500bn from the general EU budget (overall expected spending of € 1.5tn over the next 10 years, i.e. 1/3 of the EU budget dedicated to climate action)
-€ 300bn from the InvestEU fund (financing provided to private investors by the European Investment Bank (EIB), leveraging on guarantees provided by the EU itself)
-€ 100bn from the Just Transition Mechanism (grants to support economies suffering the transition to a climate neutral EU).
The remaining portion should be funded by single country programs.

A positive acceleration to the EU's Sustainability Commitment

As the world was struck by the Covid-19 pandemic, investors and experts feared that the momentum built around sustainability investments would fade in the wake of a sudden and deep recession. However, the July 21st agreement reached by the European Consilium on the EU's 2021-2027 budget (the so-called Multiannual Financial Framework, "MFF") and the Next Generation EU fund (NGEU, referred to as "Recovery Fund") shows that public support for climate action remains unabated. The proposed interventions represent a material increase in visibility on the resources for the EU Green Deal.

The prime ministers of the 27 member states agreed to a € 1,074bn EU budget for 2021-2027 (largely aligned to the previous MFF) and a one-off support measure (NGEU) amounting to € 750bn earmarked for individual countries, to fight the economic backdrop of the Covid-19 pandemic, of which € 390bn as grants and € 360bn as loans. Finally, the EC has made available the SURE fund (up to € 100bn of loans) to support temporary unemployment measures by the countries hit by the pandemic. The liquidity for the NGEU will be raised on the debt markets by the first dedicated issuance from the EU itself. To guarantee the repayments and cheap cost of funding, all the member states have provided a guarantee to cover the fund, equal to 0.6% of their respective GDP. On top, the EC has indicated 4 new potential sources of revenue to cover the interest costs and the principal repayments: i) a tax on non-recycled plastic packaging waste of € 0.8/kg (potentially reaching up to € 9.5bn/year according to Ambienta estimates), ii) the extension of the Emissions Trading System to marine and airline emissions, iii) a carbon border tax and iv) a financial transactions tax. Many details on the timeline and the nature of the agreed spending are lacking, pending required legislative implementation from European and national parliaments. Our analysis based on the known elements shows the potential impact of the transfer of funds on the economy of the countries hardest hit by the pandemic and on the available resources for green investments over the next 10 years.

Ambienta Analysis: the Impact of EU Funds on Selected Countries and Sectors

In the following table (exhibit 1) we show estimates, based on the allocation keys set by the EC for the NGEU, on the liquidity that will be provided to some European countries. The outlays must be specified in spending plans submitted to the EC. Of the grant portion, at least 70% must be committed by the end of 2021 and 30% by the end of 2022. The loans will likely have a similar timing, therefore most of the transfers will happen between 2021 and 2024.

Exhibit 1: The Recovery Fund Country Split

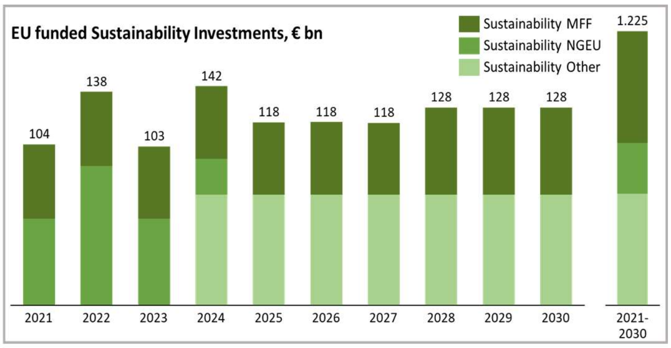
COUNTRY	LOANS € BN	GRANTS € BN	NET GUARANTEE[1]	NET GRANTS % 2019 GDP[2]	TOT LIQUIDITY % 2019 GDP
Italy	98	81	11	3.9%	**10.0%**
Spain	95	78	7	5.7%	**13.9%**
France	0	40	15	1.0%	**1.6%**
Germany	0	27	21	0.3%	**0.9%**
Greece	27	22	1	11.1%	**26.1%**
Portugal	19	16	2	6.9%	**16.5%**
Netherlands	0	7	3	0.5%	**1.1%**
Total EU 27	**360**	**390**	**76**	**2.3%**	**5.4%**

Source: Morgan Stanley Research and Ambienta elaborations on EC data
1: Net Guarantee = Guarantee - lower Transfers to the EU for 2021-2027 MFF
2: Net Grants = Grants – Net Guarantee

The net transfers (the real "free money" from the EU, column Net Grants above) to the worst hit economies are quite limited, except for Greece and a few other countries. But the amount of liquidity available at close to zero cost is highly relevant to navigate the recession, particularly in the context of many Southern European countries with limited room to manoeuvre in terms of fiscal spending and access to funding. In addition, the NGEU is the first real step towards mutualization of debt and fiscal policy in the EU. The repayment of the grants, which starts in 2030, will be completed as late as 2058, showing a unanimous long-term commitment to the European project. Additionally, should the four envisaged levies be successful, an actual real transfer towards weaker economies would be accomplished.

Focusing on sustainability, the agreement has shown the first firm commitment of a minimum 30% of both the MFF 2021-2027 and the Recovery Fund to climate action. Additional resources should be available for investments in other sustainability areas (see exhibit 4 below). According to our calculations on the expected timing of the use of the Recovery Fund and the yearly flows of the EU budget (exhibit 2), it is foreseeable that the EU will advance the run rate of the EU Green Deal investment plan (vs previous run rate € 100bn/year), increase the visibility of the funds committed and grow the overall amount by € 225bn from € 1tn to € 1.23tn, thanks to the addition of the 30% of Recovery Fund green component.

Exhibit 2: Annual EU sustainable investments



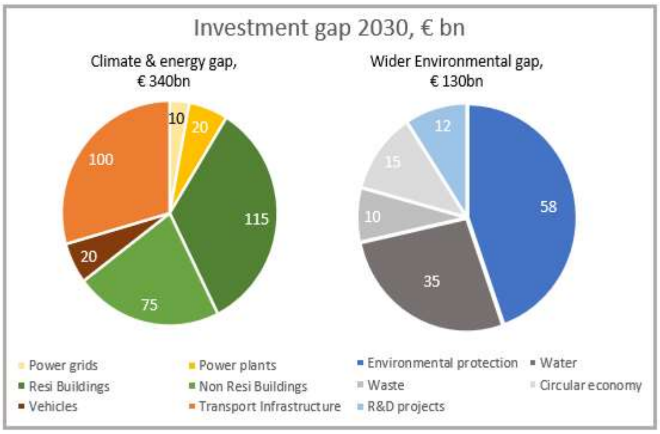
Source: Ambienta elaboration on EC data

When comparing the expected levels of green investments with the previous EU budget, a clear and marked step up becomes apparent: between 2014-2020 climate action had virtually no defined support (€ 3bn).

The nature of these investments is still undefined. The EU Green Deal is centred around 7 main policy areas (*From Farm to Fork, Biodiversity, Sustainable Agriculture, Energy System Integration and Hydrogen strategy, Sustainable Industry, Building and Renovation, Sustainable Mobility, Eliminating Pollution*). Most of the related papers are yet to be published. It is likely that the EU will require compliance with the EU taxonomy for private sustainable investments (to be defined in the coming months) also for the bulk of the EU Green Deal.

To assess the potential investment needs required by individual sectors to meet the 2030 targets, we have relied on an EC document released in May 2020 (*Europe's Moment: Repair and Prepare for the Next Generation*). It estimates that the yearly investment gap vs the 2016 baseline year is € 340bn between 2021 and 2030 for climate mitigation and energy transition and a further € 130bn for environmental protection and natural resources management (exhibit 3). This annual investment gap will not be covered by the EU Green Deal Investment plan alone. The € 1.23tn already committed (EU Green Deal + 30% of Recovery Fund), covers 26% of the required incremental investments. Private money and support from member states will be required to bridge the difference.

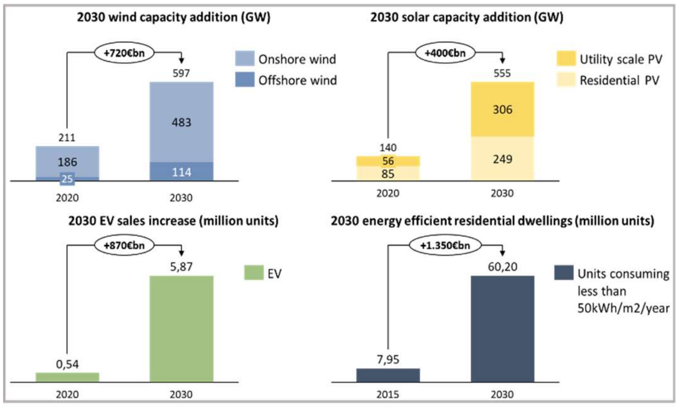
Exhibit 3: Annual Sustainability Investment Gap



Source: "Commission Staff Working Document, Identifying Europe's Recovery Needs", Brussels, 27 May 2020

To assess these projections, we have focused on the split in terms of GHG emissions in Europe to meet the Paris Agreement (maximum +1.5 °C vs preindustrial temperature) according to Bloomberg NEF (BNEF). The total cut of CO2e needed to comply is -870Mt vs 2020. The largest decrease is expected in Energy production (-480Mt), followed by transport (-198Mt) and buildings (-135Mt). We have reverse-engineered the required capital expenditure needed to tackle these cuts. Altogether, our analysis has identified an investment potential of more than € 3tn in the sectors of renewable energy generation, electric cars and residential buildings energy efficiency alone. These investments can help achieve a cut of roughly 800Mt CO2e/year by 2030 (exhibit 4). The amount calculated is an absolute level of investment while the EC projection represents an investment gap. The value we have calculated is lower than the € 4.7tn estimated by the EU, as we have focused only on GHG reductions and 4 main sectors. However, the yearly amount estimated by the EC is consistent with our calculation in both Renewables and Residential renovation. The EC seem to be largely underestimating the spending needed in Electric Vehicles (EV), possibly because it is mostly based on the substitution of Internal Combustion Engines and normal vehicle replacement demand.

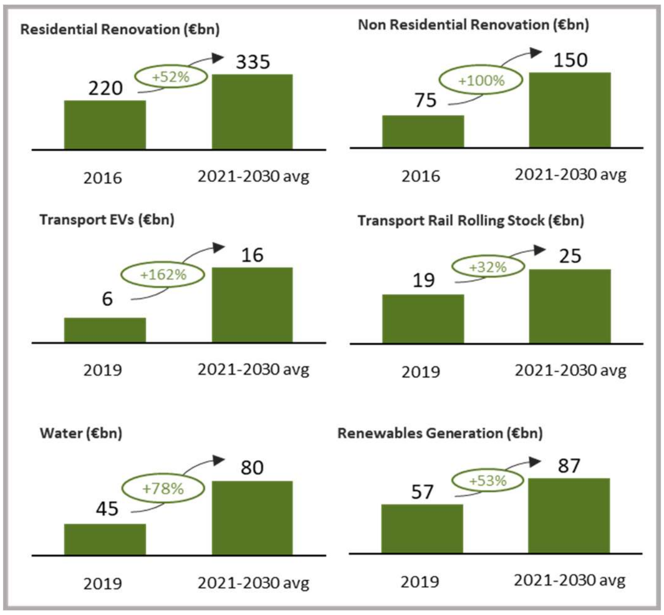
Exhibit 4: Incremental Investments in key sectors



Source: Ambienta elaboration on EC and BNEF data

To better understand the potential impact on the growth rates of some key sectors, we have compared the baseline year capital expenditure with the average increase in the run rate of investments for the next 10 years required to hit the 2030 targets, based on the EC investment gap projections (exhibit 5). Assuming the EU support dedicated to sustainability will be split according to the sectorial breakdown shown in exhibit 3, EU funding will cover 26% of the required investments across all sectors.

Exhibit 5: Increase in the annual investments in key sectors



Source: Ambienta elaboration on EC, BNEF, Alstom data

The most relevant step up is foreseen in non-residential energy efficiency and electric mobility. Water infrastructure is set to see a marked acceleration of growth as well. Residential renovations, renewables generation and rail rolling stock will see a relatively more contained growth due to the higher absolute baseline and the more established nature of these markets.

To summarize our key findings:

- **The first step towards fiscal transfer and common funding in the EU:** the EU Recovery Fund represents a marked increase in terms of EU budget for the next 5-7 years and is the first sizeable common debt issuance exercise to provide a fiscal transfer mechanism in the EU
- **Funding for grants coming from polluters:** the funding mechanism to sustain the grants portion of the Recovery Fund entails 3 potential sizeable levies on unsustainable economic activities (plastic packaging, Air and Marine travel pollution, high intensity CO2 industrial processes) to cover the money transfer to the economies worst hit by the pandemic
- **2020 to mark a step change in sustainable investments in Europe:** after Covid-19 the visibility of the EU Green Deal has improved. The EU funding is larger, and the portion committed to sustainability has risen from a 25% aspiration to a 30% firm commitment. We now have an unprecedented visibility on >€ 120bn yearly EU funding to sustainable investments up to 2030
- **Water and building renovations to benefit the most:** there is still uncertainty on how the funds will be invested, but our educated estimates see best growth opportunities in: Building Renovation, Water Treatment and Infrastructure

Conclusion

The recent steps undertaken by the EU to tackle climate change and the recession caused by Covid-19 are highly relevant for sustainability investments. The EU reaction plan, albeit with its typical dose of brinkmanship, has shown an increase in resources available for the common budget, new steps towards fiscal convergence and support for the periphery. Long- term commitment up to 2058 for the European project has been shown by the first sizeable EU debt issuance. The EU Green Deal will provide policy support and funding to accelerate investments in sustainability. However, private intervention will be essential to achieve the sustainability targets, as subsidies and policies alone will neither suffice nor succeed.

In our opinion, the only way to fully address climate change is through environmentally sustainable technology that generates an appropriate return on capital. We are convinced that great value can be generated by investing in these winning technologies. Resource efficiency and emissions reduction will be the source of above average growth and competitive advantage over the next decades. The EU Green Deal, the EU Budget for 2020-2027 and the Recovery Fund are steps in the right direction. They can generate a virtuous cycle of acceleration in environmental sustainability trends over the next 10 years. Many details are still lacking and the way these abundant resources are to be actually invested is key. The EU must avoid subsidizing unproductive current spending of single countries' budgets and focus on high multiplier investments that can kickstart a sustainability-led recovery.

According to Ambienta X, the most interesting investment themes in sectors that are expected to benefit in terms of growth acceleration going forward are as follow: buildings energy efficiency (Kingspan, Sika, Schneider Electric, Legrand, Spirax Sarco, Covestro, Munters); decarbonization of power generation (RWE, Enel, Ørsted, EDP, Iberdrola, Vestas); electrification of mobility (Infineon, STMicroelectronics, Albemarle); development of rail infrastructure (Alstom, Knorr-Bremse); water treatment and distribution.

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Ambienta X is the public markets division of Ambienta SGR S.p.A., a sustainability-focused asset manager established in 2007. Ambienta X is led by Fabio Pecce, who is accompanied by a team of partners and seasoned professionals embracing the same ethos and values.

In May 2020, Ambienta launched the Ambienta X Alpha Fund an Irish ICAV UCITS, managed by the Ambienta X team.

The Fund's objective is to generate attractive risk-adjusted absolute returns, through capital appreciation and income. The Fund intends to achieve this by investing primarily in equities and equity-linked securities of companies worldwide exposed to Environmental Sustainability ("ES") trends.

ES is a key driver of the investment strategy and is embedded in the portfolio selection process. This acts as a powerful engine of idea generation: i) as a rigorous filter to highlight attractive companies (potential Core Longs), and ii) a disruptive force impacting incumbent franchises or overvalued green-washed companies lacking sustainable competitive advantages (potential Core Shorts).

Ambienta X leverages the internal expertise and knowledge built by Ambienta over the past decade around the ES impact on sectors and value chains. Ambienta X collaborates daily with Ambienta Sustainability & Strategy ("S&S"), a team dedicated to fundamental research and the support of the investment divisions.

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