

EVALUATING SUSTAINABLE WINNERS & LOSERS OF THE COVID-19 CRISIS

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Key takeaways

- Corporate resiliency is being redefined amid the coronavirus crisis as the public health tragedy tests the global economy in unparalleled ways.
- This market environment presents a unique opportunity to test our sustainable investing thesis as the crisis unfolds.
- Few sectors have been immune, but many of the sustainability-focused corporate credit sectors have demonstrated resiliency, supporting our belief that the long-term secular trend towards a sustainable global economy will persevere through and extend well beyond the crisis.

Uncertainty continues to plague financial markets as investors grapple with the economic ramifications of the coronavirus pandemic. In a matter of weeks, Covid-19 and the associated containment efforts have thrust the global economy into a recession and tested the resiliency of corporations. While few areas of the market were left unscathed, certain companies and sectors have demonstrated greater resilience than others.

Evaluating our sustainability thesis

Coming into the crisis, advocates for sustainability-themed investing like us believed that those companies with a greater focus on sustainable products, services and business practices may possess greater resiliency in the event of a systematic shock. In theory, companies that better manage risks may have the wherewithal to weather unforeseen circumstances with plans in place to pivot their businesses accordingly. Further, an alignment with long-term secular trends, such as the shift toward sustainability, may help minimize short-termism and cyclical risk.

The current market environment has presented a once-in-a-generation opportunity to test this thesis in real-time. While few could have predicted that the pandemic would create an exogenous shock of this magnitude, we've found that this sustainability theory has held up well in the face of an unparalleled public health crisis and market fallout, particularly when we focus our sights beyond the end of the current economic malaise.

One reason for the theory's success, we believe, is that the Covid-19 outbreak and ensuing recession have done little to derail the long-term shift towards sustainability. Companies with a greater focus on sustainability, such as technology and healthcare, have weathered the downturn relatively well. Meanwhile, industries such as energy and leisure, have suffered immensely. But it's not black and white—even within the realm

of sustainability-focused sectors, there have been winners and losers. For example, global containment measures are providing tailwinds for sectors such as food and beverage and communications. Meanwhile, power, including renewable energy, will continue to face headwinds in the near future.

While many unknowns about the virus remain and the true winners and losers won't be revealed until the crisis runs its course, this environment provides a unique opportunity to test our sustainability theory. Below we outline our view of corporate credit sectors related to our sustainability-themed investment strategy and their likelihood to emerge as winners and losers.

Assessing sustainable corporate credit sectors

Positioned to win



Technology: The demand for technology has never been stronger. As people around the world are contained to their homes, demand for many technology products and services has spiked. With the uptick in demand, companies involved with technology solutions including energy efficient cloud services, which enable people to work remotely and/or facilitate distribution of products and services from a distance, are currently at a premium.



Communications: Wireless and Internet operators, tower operators and others that support the wireless and Internet value chains are benefiting from the quarantine efforts and work-from-home environment. In many cases, wireless and Internet have become the sole sources of communication for people stuck at home. The need to provide communications services to the un/under-served through wireless and Internet is even stronger now than before the crisis.



Pharmaceuticals and biotechnology: For a sector that was, up until March, often perceived as an enemy of the people due to the ongoing opioid crisis and rising drug costs, sustainability has, to some extent, come to the sector's rescue. The need for new cures and vaccines for diseases like Covid-19 is more in focus today than in recent years, reaffirming the critical importance of innovation within pharmaceutical sector. The current crisis highlights the long-term sustainability potential of companies that are working to find solutions to major, neglected and orphan diseases globally. These developments could improve the public opinion of the industry, which may lessen the pressure for drastic reforms known to hurt innovation while also helping companies attract and retain talent.



Food and beverage: Although not specific to healthful food, sales of food and beverages in general sold through traditional grocery stores, mass retail and club stores has spiked materially as people have shifted consumption habits from a mix of at-home and away-from-home eating to almost entirely at-home. Sales of healthful food products have risen materially, too.

Positioned for mixed results

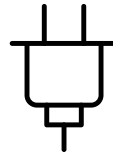


Home construction / building materials: Regardless of how affordable a new home is, few consumers are touring—much less buying—new affordable homes right now. Furthermore, renovations of existing homes have slowed, suggesting the demand for energy efficiency-enhancing building materials has declined as well. That said, many markets had existing housing shortages that will not go away just because of the Covid-19 crisis. As a result, the need for affordable housing and energy efficient building materials is still high and activity will likely recover once stay-at-home mandates have been lifted.

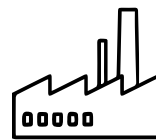


Financial services: Given the outsized impact on small and medium-sized enterprises in this recession, the need to support these SMEs is substantially more pressing now than it was before the crisis. Although financial services firms that emphasize lending to or provision of other financial support to SMEs before the crisis began may see larger increases in loan losses and greater lost revenue, they also provide a critical conduit for the provision of the emergency loans from governments around the world, such as those

provided for under the CARES Act here in the United States. In addition, providing financial support to these firms today may prove to be a profitable investment when the economy recovers.

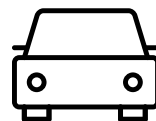


Power: The demand for electricity is highly cyclical, and the current recession is no different, regardless of whether or not the electricity is generated from renewable sources. That said, we expect the long-term transition to low-carbon energy sources will persist, supporting the ongoing decline in cost of renewable power from solar and wind.



Industrials: Many industrial sectors, including those that sell sustainable products and services, are highly cyclical. For example, the need for environmental services will decline as general industrials demand declines. Further, chemicals companies that sell resins that go into wind turbines will see weakened demand as the demand for power declines with the weaker economy. However, we'd have to see a prolonged drop in energy demand to overwhelm that secular trend of clean energy taking share from fossil fuel energy before we see a material impact on demand for resins going into wind power. Other areas of the industrial sector are experiencing an uptick in demand. For example, the paper and forest products subsector is benefiting from increased demand for paper packaging, which we view as generally more sustainable than plastic packaging, as consumers resort to online shopping while in containment.

Positioned to lose



Automotive: Big ticket, consumer discretionary spending is taking an obvious hit. Autos and auto parts are no exception, regardless of whether they're electric, hybrid, or internal combustion engine-powered. US seasonally adjusted annual rate (SAAR) has been running at 17 million the last several years, but is expected to decline to 12-14 million for the next 12 months. That said, we believe this crisis will not slow the long-term, secular trend towards electric/hybrid vehicles.



Commercial real estate: Whether or not a commercial real estate property is LEED-certified, the need for commercial real estate has dropped amidst stay-at-home mandates. Some sectors are better positioned to hold up okay in this market(e.g. multifamily, distribution warehouses,

data centers), other sectors will likely take years to recover (e.g. hotels, retail), and still other sectors, like offices, may be changed forever as companies realize the potential value of offering employees greater work flexibility. Healthcare REITs, notably the life science, medical office, skilled nursing, and hospital property types, will likely face near term pressure from rent deferrals, but long-term demand fundamentals remain intact. Nonetheless, we still believe that energy-efficient buildings have a higher likelihood of survival than inefficient ones, suggesting the trend towards LEED certified and Energy Star buildings may persevere.

Lessons in sustainable investing

Many of society's greatest lessons and innovations have risen out of tragedy. From resilient supply chains and labor management, to improved healthcare systems and new business innovations, we are learning many lessons from this pandemic. Further, we believe the crisis will continue to provide opportunity to evaluate our sustainability thesis.

While some may question the viability of sustainability initiatives in the short-term as issuers shift focus on short-term issues and re-evaluate their capital expenditures, we believe long-term secular sustainability trend will persevere through and extend well beyond the crisis. For others, the pandemic has been a wake-up call to take action and quickly adapt their business model to provide the products and services the world needs right now, not only to solve problems caused by the coronavirus, but also take into account the wider stakeholder group beyond creditors and shareholders. To that end, we firmly believe that companies solving the world's sustainability problems are more likely to be around tomorrow, providing good opportunities for investors to generate long-term value.

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