

Small companies and the challenge of net zero

Small countries are leading the way in the race to net zero. Of the 193 members of the United Nations, only two have achieved net zero carbon: Bhutan and Suriname. In fact, they have surpassed this much talked about goal. Both countries are currently carbon negative. They remove more carbon than they emit.

At the other end of the net zero spectrum sits Australia, which has loosely expressed ambitions for carbon neutrality sometime in the second half of the century. China's target is for 2060, a full decade after the world needs to achieve net zero if it is to meet the terms of the Paris Agreement and limit global warming to well below 2°C.

Of course, it is not completely fair to compare Bhutan (population: 700,000) to China (population: 1.4 billion), a nation that accounts for some 25% of global emissions. The point, however, is that every country has to play its part in the global race to net zero.

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As Small & MidCap investors, we believe that every company will have to play its part too, even as the focus of many stakeholders remains on the world's largest companies.

A recent report from "Bankers for Net Zero" highlighted the risk of neglecting smaller companies, which in the UK account for 52% of turnover and a quarter of the workforce: "self-evidently, the UK Government cannot meet its long-term climate goals if it doesn't take the 99% of British businesses with fewer than 250 employees with it". The same is true in the US and Europe, where net zero pledges by small companies lag their LargeCap counterparts.

The challenges and frustrations voiced by small companies in the report echo what we hear from our own investee companies. We have spent the last three years engaging with companies to understand the challenges they face in tackling climate change.

Announcing a net zero target is easy. What comes next is more complex. What steps do companies need to take to deliver on a goal that is in the distant future? How should net zero be defined? What reporting expectations do shareholders have? Can companies use carbon offsets, and if so, which ones and under what terms? Some shareholders want Task Force on Climate-Related Financial Disclosures (TCFD) reporting (and indeed this may soon become mandatory for companies of a certain size). Others wish net zero goals to be verified by the Science Based Targets Initiative (SBTi). Certain investors are happy if companies ignore Scope 3; others want detail on the full range of scope emissions.

Deciding what to do is difficult. There is no precedent and the stakes are high: targets that lack detail can at best be perceived as underwhelming and at worst greenwashing, feeding the scepticism of those questioning the net zero agenda.

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Companies are operating in an environment where it is largely up to them to work out the answers to such questions. This is resource intensive. One of our companies informed us that due to differing standards they would only update their sustainability report every other year. Understandably, they lack the internal resource to solve the puzzle of climate reporting.

Others have ignored headline targets altogether. A water technology business in which we invest has specifically not set a net zero goal. Management is instead trying to achieve a series of interim environmental goals for 2025, allowing them to better understand the company's environmental pressure points and challenges. Once this work is done, they can set a net zero goal in the confidence that it will be met.

What solutions can we bring to smaller businesses to help them navigate these challenges? We plan to continue our net zero engagement project. An aim this year is to understand how executive pay is linked to and aligned with climate change related goals. To borrow a phrase from Mark Carney, a "tragedy of the horizons" exists where today's CEOs - those setting net zero targets - are unlikely to be running the same companies in 2030 or 2050. Current incentives should be aligned with the transition to net zero.

We are honoured that Montanaro has been invited to join a taskforce coordinated by The Glasgow Financial Alliance for Net Zero (GFANZ) and chaired by Mark Carney, in his role as UN Special Envoy on Climate Action and

Finance. The purpose of the taskforce is to improve guidance to corporates on the financial sector's expectations for credible transition plans.

We hope to use our experience alongside other members of the taskforce to ensure that the setting of standards can be applied not just to the companies at the top of the equity pyramid, but smaller companies too. While the world's largest companies account for a substantial proportion of emissions, there are 10 times more Small and MidCaps across global equity indices. Unless we take them with us, we can all forget about living in a net zero world.



By Ed Heaven

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