

Kempen Global Listed Infrastructure

JULY 2020

INFRASTRUCTURE IS KEY IN A SUSTAINABLE WORLD

Over the past decade there has been an increasing focus on Sustainability issues impacting society. We believe the coming decade will see a step change in Sustainability issues. In this paper we outline this change, the role of Infrastructure, and how our investment process captures the opportunities ahead.

- The focus on Sustainability has been supported by two international agreements; Paris Climate Agreement and the UN Sustainable Development Goals. First we explain treaties and outline our expectations.
- We then demonstrate how infrastructure assets play a key role in reducing global carbon emissions and its contribution to the UN SDGs (especially in the utilities and energy infrastructure segments).
- Lastly we describe how our Fund allocates capital to those companies that reduce emissions significantly. We demonstrate in this document (and appendix) how important it is to focus on multiple forward-looking criteria, as a snapshot of today will not adequately address the risks and the opportunities.

PARIS CLIMATE AGREEMENT AND UN SUSTAINABLE DEVELOPMENT GOALS

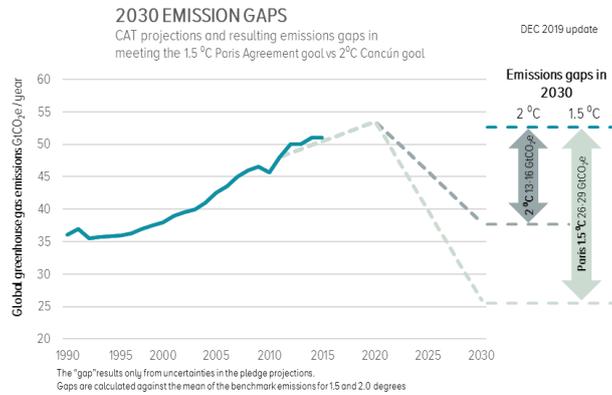
The Paris Climate Agreement was signed by 197 countries in December 2015. The aim of the agreement is to avoid dangerous climate change by limiting global warming to well below +2°C and pursuing efforts to limit global temperature increases to +1.5°C above pre-industrial levels (c.1900). The execution of this agreement relies on reducing as soon as possible the emissions from Greenhouse Gases ('GHG', Carbon dioxide being the most common), which for the latest available year (2019) are at 55.3 giga tons of CO₂ equivalent emissions according to the "Emissions Gap Report" of the UN (1 giga ton is 1 billion tons). The near term goal to 2030 is to reduce emissions by half to track the 1.5°C scenario, whereas -25% would track the 2°C.

Longer term, the goal for 2050 is to reduce emissions towards 'net zero' for the 1.5°C scenario. Net zero by 2070, would lead to the 2°C. Net zero means producing only the CO₂ that can naturally be absorbed (25% by oceans, 25% by Trees & Soil, and 50% by the atmosphere) without further warming the planet. CO₂ stays in the atmosphere for 300-1000 years, hence the urgency to reduce sooner rather than later. Even if we would cut CO₂ emissions to net zero today, we still have a significant period of warming ahead of us.



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Figure 1: 2030 Emissions Gaps



Source: "Emissions Gap Report 2019" van de VN

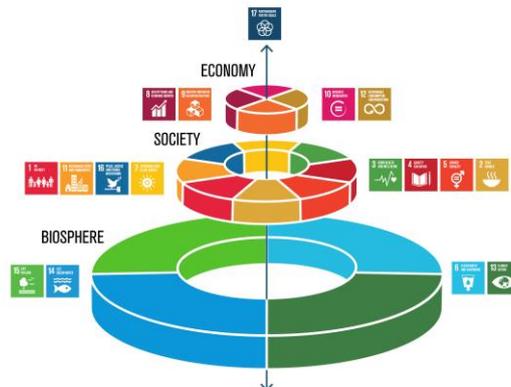
From the Emissions Gap chart above, there are two observations to be made:

1. Since the agreement was signed, CO₂ emissions have continued increasing.
2. The country pledges made so far, are not enough for the Paris ambitions.

The exception is expected to be 2020, where due to Covid-19 lockdowns, CO₂ emissions are expected to drop 8%. Interestingly, this is roughly the percentage drop required each year for the 1.5°C, which shows just how difficult this challenge is.

Also from 2015, the UN published the now much publicized 17 Sustainable Development Goals out to 2030. The philosophy behind these goals was that the planet enables society, which enables the economy. As such these 16 SDGs target different layers of the planetary, societal and economic issues. The 17th SDGs simply states that co-operation will be needed to achieve these goals.

Figure 2: 17 Sustainable Development Goals

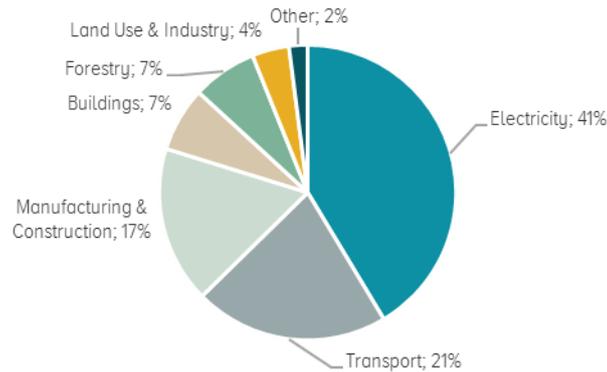


Source: Sustainable Development Goals VN, Jerker Lokrantz/Azote (Graphics)

The UN SDGs are not discrete and separate, but sometimes overlap – namely climate change with SDG 1 (Poverty), SDG 2 (Hunger), SDG 6 (Water), SDG 7 (Affordable & Clean Energy), SDG 13 (Climate Action). Hence mitigating climate change, contributes positively to several other SDGs. This has been further described in the UN International Panel on Climate Change 1.5°C report (2018).

A common misconception is that there is one path to follow to decarbonize. From UN Climate Watch data, Power Generation & Transport are almost two-thirds of the CO₂ from human activity. Given how many different sources there are for CO₂ emissions, reducing emissions can take several different pathways. One thing that is certain, is that the impact will affect wide sections of the economy and society, but also the infrastructure that we need.

Figure 3: Sector Breakdown of CO₂ emissions



Source: Climate Watch Data, 2016

Going forward: Increasing urgency and new green deals

In the past 12 months, the recognition of societal lack of progress towards meeting Paris Goals or UN SDGs, has been met with increasing regulation and renewed ambition to succeed, such as new Green Deals on climate issues. Some prominent examples being the EU Green Deal, or early indications on China's 14th five-year plan for the Power Sector (expected in March 2021), to various countries tying Covid-19 recovery measures to decarbonization. This is prepared in advance of the first 5 year review of the Paris Climate Agreement (2021). At this meeting each country's ambition levels are expected to be raised, as their current ambitions are not enough for the 1.5°C goal.

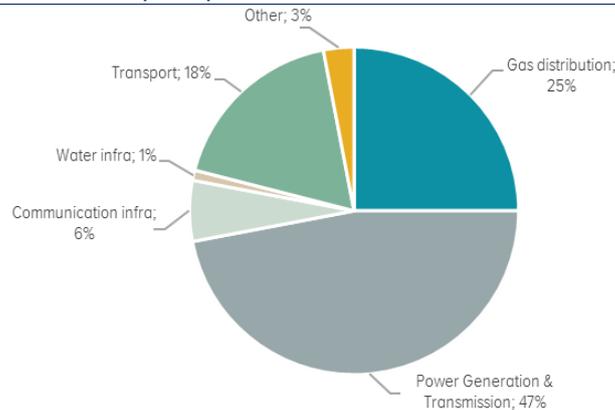
During the UN SDG summit in September 2019, there was a call to make the 2020s the 'Decade of Action' on all 17 goals, as a response to actions being taken too slowly to address these challenges. We expect an increased focus from governments, regulators, and businesses on sustainability issues in the decades to come.

(LISTED) INFRASTRUCTURE AS BACKBONE TO BECOMING SUSTAINABLE

Many of the sustainability challenges for the Energy transition and the UN SDG's will be met in the Listed Infrastructure asset class. The infrastructure benchmark has significant exposure to Power generation & Transmission, Gas distribution and Transport infrastructure. Significant investment will be required for the sector to change the energy mix, facilitate greener transport, while connectivity will require additional investment in digital infrastructure. As a result, we believe that infrastructure will become one of the fastest growing sectors in the next 30 years. The private sector will be incentivized to invest in expanding and upgrading for greener infrastructure as governments balance sheets are stretched but fiscal stimulus is required for further growth.

Beyond the Energy transition which overlaps SDG 7 Affordable and Clean Energy, other SDGs are well represented in Listed Infrastructure starting with SDG 9 emphasis on Resilient Infrastructure, to SDG 6 focus on Clean Water.

Figure 4: Listed Infrastructure benchmark exposure per sector based on revenue

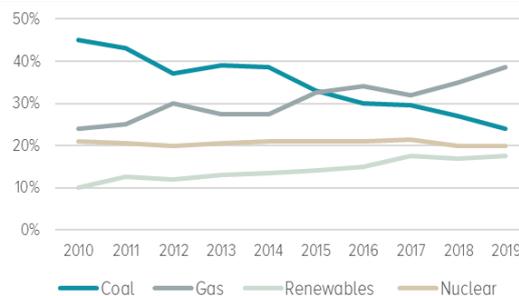


Source: Kempen, FTSE Global Core Infrastructure 50/50, 2020

Power Generation & Distribution – renewables becoming more competitive

Over the last decade carbon emissions from the US & EU electricity sectors have declined significantly. Decarbonizing from the phase out of coal, and investments in renewables are becoming more common – driven by supportive regulation, and renewables (and gas) becoming cheaper than coal to generate electricity. As we see from the chart below for the US, a decade ago the Energy mix was 45% coal. Last year it was “only” 25% as gas and renewables gained market share.

Figure 5: US Power mix generation since 2010



Source: US Energy Information Administration, net generation by energy source 2010-May 2020

Gas distribution – a transition fuel, reducing water consumption

Also from the chart above, we see the role of coal to gas switching for the energy transition (gas has less than half the CO₂ of coal in power generation). According to the “Electric Power Monthly” of the IEA, in the last decade coal to gas switching “saved around 500 million tonnes of CO₂, an effect equivalent to putting an extra 200 million EVs running on zero-carbon electricity on the road”. The IEA also forecasts gas capacity increases for the coming decades.

Water conservation is an overlooked benefit of coal to gas switching, as each mega-watt of coal power replaced by gas, saves 39 700 liters of water. Put another way, if all US coal power was replaced by gas, the water savings alone would be equal to the annual water used in the US. This is a significant and direct contribution to UN SDG 6 related to Water.

Transportation sectors (road, rail, airports) – reward EV infrastructure

The developments observed in the utilities sector illustrate the changes we could see in the transportation sector. Electric vehicles are gaining market share, reducing carbon emissions in the transportation sector. We believe that investors will reward companies that promote electric vehicle infrastructure which has direct impacts on the Rails, Toll roads, Airports, and Ports sectors within Infrastructure. What is more, several shifts are likely to occur including from Truck to Rail for freight, Road to Rail for commuter transport, and from Plane to Train where possible.

New infrastructure sectors – Significant opportunities ahead

Beyond traditional infrastructure, there are new sectors that emerge or will emerge as infrastructure will also meaningfully contribute to decarbonization:

- Today we see connectivity impacting data consumption & transport. This impact the data centers, and Communications Infrastructure in general.
- Tomorrow's technological breakthroughs in Battery Storage or Carbon Capture will create new opportunities for global infrastructure. As the cost curve has come down, battery storage will be used more frequently by utilities to back up wind- and solar-parks.

KEMPEN GLOBAL LISTED INFRASTRUCTURE FUND & SUSTAINABILITY

We believe that Infrastructure, and especially utilities, are in focus to drive the energy transition. Allocating capital appropriately can result in significant carbon reductions and more sustainable portfolios. ESG is key in our investment process. Our aim is to steer capital to the companies which are making a difference, and hence to offer an infrastructure fund that supports the transition to a more sustainable world. In our view, it is short-sighted to solely focus on the current situation of where a company is. We start by recognizing that the journey towards being sustainable is longer term in nature, and companies will be at different points along that path.

In line with the University of Cambridge Institute for Sustainability guidelines, we take a holistic approach to integrating ESG issues into company analysis. By taking this approach, we believe we can combine financial outperformance and ESG improvements as the pathway is not always reflected by capital markets.

A more sustainable portfolio with lower carbon footprint

The first step is determining how far along the path towards becoming sustainable, a company is. We assess this using two tools – the first is from reported or estimated carbon emissions data, which gives the point in time snapshot of where the company is. The second is the ambition level the company is set (CO2 reduction goal, and target date).

Some companies will have CO2 emission levels that show much of its journey is still ahead (the box on the left in the illustration below). Other companies may have an elevated CO2 footprint today, but credible targets (clear milestones, linked into managements long term incentive plans) that show it is on the sustainability pathway, but more needs to be done to align to Paris – the box in the middle. Finally we have companies that have goals aligned to Paris and contribute to decarbonization – the box on the right. At this moment we have 2 companies with no clear alignment (2% of our portfolio), 14 companies are on the pathway but not decarbonizing in line with Paris ambitions (34% of our fund), and preliminary indications that 21 companies have goals that align with Paris (63% of the fund) by targeting at least a 50% reduction by 2030. Not all companies have yet set targets out to 2050.

Figure 6: Overview of companies which are aligned with Paris in the Kempen (Lux) Global Listed Infrastructure Fund



Source: Factset, company reports, Kempen

As investors we have a healthy obsession with what a business can become in future, not just what it is today. An example of this process in action is provided in appendix 1.

The further to the right of the sustainability pathway a company is, the higher the ESG score for that company, which in turn allows us to allocate more capital to those companies if it is not yet reflected by capital markets. This has the effect of encouraging the move towards sustainability within our portfolio and society.

From a process that rewards companies for being further along the sustainability pathway, and engages for improvement, we have an outcome where on CO2 emissions per unit of Revenue, the fund has a lower footprint than the Listed Infrastructure Benchmark, as well as the transition path outlined by the EU’s Climate Transition Benchmark (EU CTB). Through the sustainability challenges ahead, continuing to deliver sustainable alpha remains our focus.

Figure 7: CO2e / Revenue of the Kempen (Lux) Global Listed Infrastructure Fund



Source: ISS, Kempen

Our qualitative scoring allows us to allocate more capital to infrastructure supporting the transition

When allocating capital, our qualitative process scores three factors – Management Quality, Asset Quality (in terms earnings power from regulation and physical infrastructure), and ESG. An equal balance between these factors forms our qualitative input. This is a change from 25% weight in ESG, that now moves to 33.3%. We proactively make this change to reflect the increased impact ESG factors will have given the upcoming Paris Climate review – with stricter goals needed, plus the ‘Decade of Action’ for UN SDGs to 2030.

Figure 8: Qualitative Scores for the Kempen (Lux) Global Listed Infrastructure Fund

Qualitative Scores	Previous Weight.	New Weight.
Management Quality (how well are the assets managed?)	45%	33,33%
Infrastructure/Regulation score (earnings potential of the asset?)	30%	33,33%
ESG (opportunities & risks)	25%	33,33%

Source: Kempen

Within this 1/3 ESG weight, we recognize that Environmental, Social, and Governance issues are fundamentally very different issues to each other. For different sectors, a different issue from the ESG factors will be more material than another. We specifically target distinct ESG metrics that matter, for each sector.

After selecting E, S, or G, we then select 5 specific sub-criteria within this factor, as indicators of conduct. For example, with Pipelines (Infrastructure includes several North American pipelines), Social issues are the more material ESG issue, as we have witnessed with protests, legal challenges against pipeline construction. To better incorporate this risk, two of the 5 sub-criteria we use in pipelines are early stage community engagement as well as an indigenous rights policy. Where we see a company scoring sub-optimally on the sub-criteria, this guides our engagement (more on that in the next section).

Figure 9: Heat map of most material ESG issue by sector

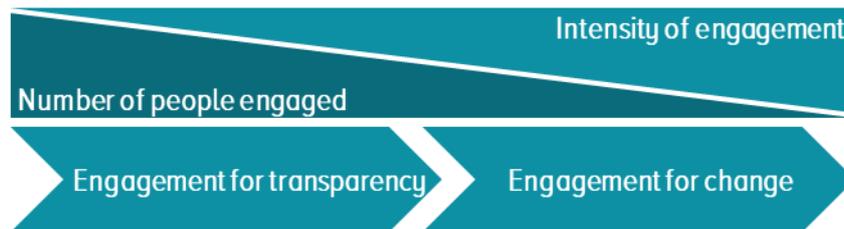
Heat Map of most material ESG issue by sector:			
	Environmental	Social	Governance
Airports			
Datacenters			
Electric Util			
Freight Rail			
Gas Distributors			
Passenger Rail			
Pipelines			
Ports			
Toll roads			
Towers			
Water			

Source: Kempen

Engagement Process – our New Active – to stimulate change

We accept that not every company can be on the right hand side of the Sustainability Pathway. Where we see a company underperforming on the key ESG issue, we actively engage with companies along the spectrum of stakeholder engagement (as described in the International Finance Corporation’s Good Practice Handbook, and Kempen’s Stewardship approach).

Figure 10: Engagement



Source: Kempen

As shown above, our preference is to begin with private one-on-one engagements with management teams. The degree of engagement can be subtle to start with, with request for information, more transparency on impacts that need to be reported. As with our peers in the non-listed space, we can also exert a degree of influence in our investments via engagements for change. This can take the form of individually or collaboratively (if needed) pushing for a different strategy, to either do more of what is sustainable or less of what is not.

An example of an engagement to change behavior (moving a company to the right of our Sustainability Pathway) is CLP Holdings. CLP Holdings is a Power Generation and Distribution company listed in Hong Kong. When we first met the company in March 2019, they were considering building two new coal power plants. We didn’t see how that idea aligned to Paris, and aimed to convince the company to move to the right on our Sustainability Pathway.

Our engagement (of in total eight conversations in nine months) has contributed to the decision of management to change its ambitions and not to build the two new coal power plants.

In the spirit of SDG 17 'Partnership for Goals', our fund relies on multi-stakeholder partnerships to inform sustainability decisions. Our sustainability network consists of different stakeholders with whom we have frequent discussions: *ESG data providers* - ISS (carbon emission score), Sustainalytics (ESG Criteria score), MSCI ESG (ESG Criteria score), *Academia* - University of Cambridge, Institute for Sustainability (Sustainability challenges), and *NGO* Greenpeace (Environmental issues).

SUMMARY

The coming decades will see a step up in efforts to mitigate the worst impacts of climate change. The Infrastructure sector will have a key role in enabling that effort. As long term investors, we will see the risks and opportunities becoming more material in our investment opportunities – which our investment process aims to better capture for alpha.

APPENDIX 1. SUSTAINABILITY PATHWAY - WHAT IS VS WHAT WILL BE: XCEL ENERGY.

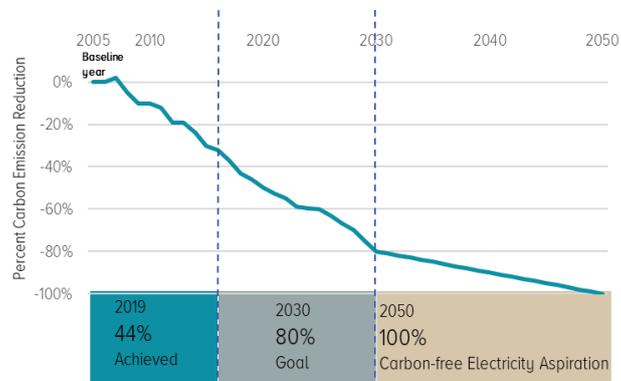
Xcel Energy is a major US Electricity Provider. According to the Carbon Disclosure Project the CO2 scope 1 and 2 emissions of Xcel Energy were approximately 47 million tons of CO2 per year. That is as much CO2 as is produced by 10 million cars in a year (for further context there are 8 million cars on the road in the Netherlands).

Although Xcel is not considered sustainable today by the EU taxonomy as too much of its electricity is still generated by coal, we do not rule out Xcel Energy as an investment (we are currently invested in this company). We looked at what this company could become, and there we find a clear road map, that we discussed with the company in person.

Xcel is firmly on the Sustainability Pathway, towards an 80% reduction in CO2 emissions by 2030 (beyond the 50% goal of Paris) and 100% by 2060, according to its investor presentation of June 2020. Credibility is added to the trajectory from a) reductions in CO2 already shown before today b) including CO2 reduction into management Long Term Incentive Plan c) transparency on the moving parts to achieve this transition.

The investment approach of focusing on how a company or its situation is changing, is also brought into our sustainability analysis, to build a more sustainable alpha.

Figure 11: Xcel Energy Carbon Reduction Trajectory



Source: Xcel's investor presentation, June 2020

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