INCOME RESEARCH + MANAGEMENT

IR+M ENGAGEMENT SPOTLIGHT
SCIENCE-BASED TARGET INITIATIVE

As the impacts of climate change continue to be a concern for many businesses, investors, and society, numerous companies have set commitments to decarbonize their operations. These commitments - often coming in the form of net-zero targets - can vary significantly, making it difficult for stakeholders to assess and compare companies' efforts to effectively transition to, and operate in, a low-carbon state. The Science-Based Target initiative (SBTi) has emerged as a leading third-party organization that has developed standards for net-zero targets, providing more clarity around a firm's decarbonization initiatives.

Given recent portfolio management-related client interest in SBTi targets, we engaged with several corporate issuers to understand the SBTi verification process in greater detail. In this piece, we provide background on the SBTi and share highlights from our discussions.

SBTi Primer

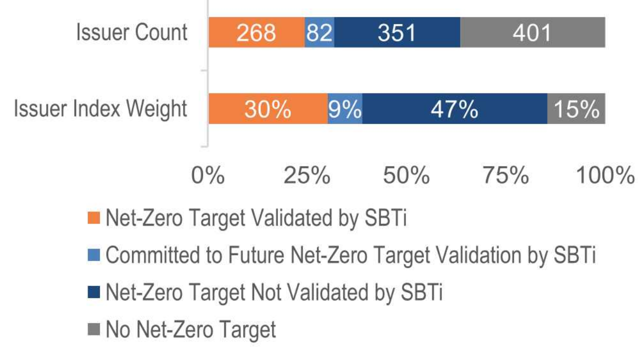
While the increasing number of net-zero targets, typically set with a target date like 2030 and 2050, may be encouraging for those concerned with climate change, these commitments can vary dramatically in scope, length, and even definition of "net-zero". This dispersion may raise questions regarding the validity and ultimate effectiveness of these targets. The [Science-Based Targets initiative] aims to assist companies with forming their net-zero targets and defining and promoting "best practice in emissions reductions and net-zero targets in line with climate science."

The SBTi itself is a partnership among various global organizations and initiatives focused on climate change and data disclosure (see footnote). Its frameworks for company net-zero targets align with the goals of the Paris Agreement to limit global warming to 1.5° Celsius above pre-industrial levels. The SBTi provides companies with "an independent assessment and validation of targets", which, in turn, gives investors a greater understanding of a firm's net-zero commitments.

The SBTi has seen significant adoption among companies wishing to develop or validate net-zero emissions targets globally.

- As of March 2024, the SBTi has 8,506 total companies listed on their website; over 5,200 have approved net-zero targets.
- 32% of the 1,102 corporate issuers in the Bloomberg Corporate Index have had their net-zero targets approved - or have committed to developing a target for approval in the future - by the SBTi.

Net-Zero Targets and SBTi Adoption Among Corporate Issuers*



**Issuers held in the Bloomberg Corporate Index as of 2/29/24*

SBTi Target Example

Sector: Pharmaceuticals

Company temperature alignment: 1.5°C

Target language: The company commits to reduce absolute scope 1 and 2 GHG emissions 42.0% by 2030 from a 2021 base year. The company also commits to increase active sourcing of renewable electricity from 29.5% in 2021 to 100.0% by 2030. The company further commits that 79.1% of its suppliers by emissions covering purchased goods and services, capital goods, and upstream transportation and distribution, will have science-based targets by 2027. The target boundary includes land-related emissions and removals from bioenergy feedstocks.

Sources: Science-Based Target initiative and Bloomberg as of 3/28/2024. Bloomberg index weights as of 2/29/2024. Companies are counted as having net-zero targets in the bottom right chart if they reported a target in either of the last two fiscal years. SBTi organizations include CDP (formerly the Carbon Disclosure Project), United Nations Global Compact, World Resources Institute, and World Wide Fund for Nature.

Engagement Overview

Within the Bloomberg Corporate Index, 351 issuers, comprising 47% of the market weight of the index, have net-zero targets that have not been validated by the SBTi. Given the net-zero initiatives already undertaken, we chose to engage with this subset of issuers to discuss whether they had considered SBTi verification and what hurdles they may face in getting their targets validated.

We sent emails to 23 corporate issuers across nine different industries and received responses from 12 issuers. In addition, we had direct conversations with seven issuers, and we found two main hurdles to SBTi adoption.

Hurdle 1: Committing to Scope 3 Emissions Reductions

Through our conversations, we found a common theme that heavy scope 3 emissions pose a significant obstacle to target validation. Firms with a high proportion of scope 3 emissions (>40% of total GHG emissions) are generally required to include those emissions in their net-zero targets submitted to the SBTi. This is a challenge for issuers with broad and diverse sources of scope 3 emissions, such as those within the Finance and Utility sectors.

- **Finance:** The banking and asset management firms we spoke with confirmed that they would be required to transition their entire financing and investment portfolios to net-zero by a certain date, which is a difficult commitment given the vast reach of their financial activities, the lack of data, and the conflicting incentives. A health insurance company we spoke with pointed out that it would have achieved SBTi validation of its net-zero target if its investment portfolio was not considered in-scope.
- **Electric:** A power trading & distribution firm we engaged with commented that regulations within the US utility industry presented a hurdle to choosing cleaner sources of energy to provide to their customers. While the firm made it a point to develop energy efficiency programs and distribute energy resources such as solar panels, it felt that the ability to reduce scope 3 emissions was limited, and the firm did not submit its target to the SBTi.

GHG Emissions Glossary

Scope 1

Direct emissions

Emissions from sources owned or controlled by a company directly

Scope 2

Indirect emissions

A consequence of the activities of the company, originating from the energy it purchases and uses

Scope 3

Indirect emissions

A consequence of the activities of the company, resulting from activities within the value chain

Examples of Scope 3 Emissions

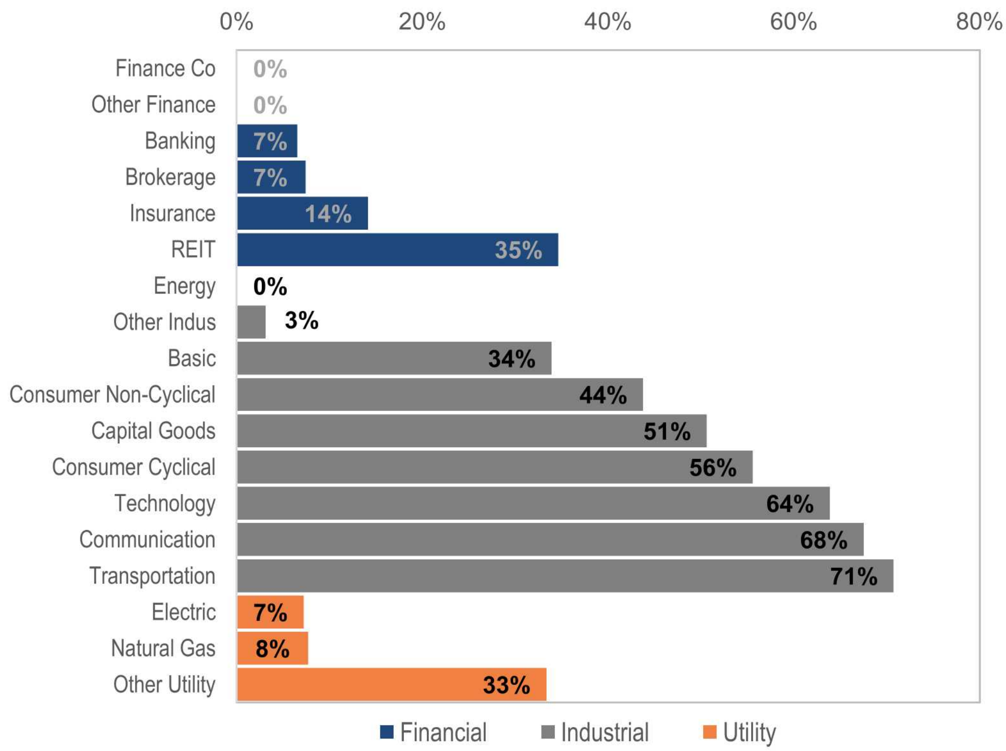
- Purchased goods and services
- Capital goods
- Employee travel
- Use of sold products
- Product transportation or distribution (upstream & downstream)
- Investments
- Leased assets

Hurdle 2: Evolving Sector Frameworks

Many of the issuers expressed concern regarding the SBTi methodologies and approval process. They believe they are too rigid, particularly when it comes to including scope 3 emissions, making it challenging for firms with nuanced or unique lines of business to obtain approval.

- **Aerospace & Defense**: We engaged with a firm in this sector, tied to the US Department of Defense, that noted data security issues when it came to scope 3 emissions. The firm found the sector guidance to be inadequate in accommodating this data issue.
- **Electric:** Multiple utility companies we engaged with noted issues with the scientific basis used for SBTi approval and preferred the development of a different methodology by the Electric Power Research Institute (EPRI). They pointed out that very few electric utility firms had committed to, or had targets approved by, the SBTi, despite the utility industry's key role in the process of decarbonization.

Proportion of Corporate Issuers* with SBTi Commitments or Validations by Sector



**Issuers held in the Bloomberg Corporate Index as of 2/29/24*

Although the hurdles identified in our discussions may be challenging for firms to overcome, we found it encouraging that some issuers had provided feedback to the SBTi regarding their obstacles. We hope the SBTi continues to develop its frameworks to incorporate unique issuer circumstances without sacrificing its goal of aligning with the Paris Agreement to limit global warming.