OPINION / COLUMNISTS

SHANE WATKINS: Why All Weather Capital is buying shares in coal mining

Investing in Thungela Resources makes sense because demand is unlikely to decline

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All Weather Capital strives to be a leader in responsible investing, and environmental, social and governance (ESG) analysis is deeply embedded in our investment process.

So you would think it odd that we at All Weather Capital are buying shares in Thungela Resources, the coal mining operation recently spun out of Anglo American. After all, coal is about as bad as you can get when it comes to highly polluting carbon assets.

Furthermore, knowledge about coal's contribution to climate change has been known for decades, yet energy from coal still accounts for 50% of global carbon emissions. So how do we explain the decision to buy shares in this company?

The origins of responsible investing date back more than 100 years when the Quakers and the Methodists laid out guidelines over the type of companies they wanted to invest in. In the 1960s, as the mutual fund industry expanded in the US, the civil rights movement and other actors in civil society started to pressure investors not to invest in alcohol, tobacco or gaming stocks.

And in SA we added our unique twist to the history of responsible investing when the anti-apartheid movement forced countries and companies to divest from (apartheid) SA.

Environmental disasters in the 1980s such as Exxon Valdez and Bhopal added to the pressure on fund managers to take ESG risks seriously. From 2000 onward climate change and the risks that dynamic poses added positively to the ESG impetus.

Interest in ESG has over the past 100 years gone from limited interest to almost ubiquitous application in fund management. So again, how can anyone support an investment in a coal mining company?

At its inception ESG was viewed as being exclusionary, meaning that certain companies and certain industries were simply excluded from portfolios on the basis that these companies were responsible for measurable and demonstrable harm.

This approach has evolved to the point now that what is required is a process that first identifies the ESG issues, then quantifies the potential costs related to the issues and then assesses the risks posed by the ESG facts identified. The company's future cash flow is then valued based on the identified future costs of the ESG issue (for example the cost of an environmental rehabilitation).

These (reduced) future cash flows are then discounted by a higher interest rate to reflect the higher risks posed by this investment. If after the application of these financial "penalties" the net present value of the cash flows is still positive or the company valuation is still reflecting an undervalued situation, then you are able to invest. In the case of Thungela we have modelled future environmental costs of R3.244bn (contingent liabilities net of department of mineral resources & energy trust cash) and increased our discount rate to a punitive 35% (15% cost of equity and 20% ESG discount). And notwithstanding these headwinds the share price still has 74% upside.

Coal demand is unlikely to decline, especially in developing countries. Existing coal-fired power stations cannot immediately be closed. A better option given the realities is to prevent new coal-fired power stations being constructed. Having invested in Thungela we would have a further responsibility to encourage company management to ameliorate the damage their operations are causing to the environment.

This management engagement is called "impact investing" and this is where responsible investors try to change the behaviour of companies in a positive manner that benefits the environment and society by improving governance.

In SA we see that our main role is to lobby for accelerated transformation of companies and their management structures to the benefit of society as a whole. ESG is a complex and nuanced issue and the best thing that fund managers can do is to become engaged so that their actions are catalysts for positive change.

• Shane Watkins is chief investment officer at All Weather Capital.