STRIVE

The Fiduciary Focus

Investment News From a Pro-Shareholder Perspective

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This Week: Strive engages Starbucks on China risk; Exxon CEO warns against villainizing oil and gas; an Eye on Energy analyzes U.S. natural gas's stabilizing force.

Straight From Strive

Strive Engages Starbucks on China Risk

As many American companies pull back on China, Starbucks has taken a different tack: Doubling down.

There's no other way to describe the company's decision to open a new store in China every nine hours for the next three years, aggressively expanding its footprint and investing hundreds of millions of dollars into the region. Climate focused investors often warn of "stranded assets"—the investment-related concern that expensive assets like oil wells and coal mines may see their value abruptly drop to $0 as the world transitions to green energy. But the there is no better definition of a truly "stranded asset" than thousands of retail stores and multi-million dollar roasting facilities that could suddenly be nationalized or seized by the Chinese government in the event that a true decoupling of the U.S. and Chinese economies occurs—a possibility that CCP-linked researchers have acknowledged.

More disturbing, Starbucks has done little to explain the rationale behind its China strategy to shareholders, much less provide a comprehensive assessment of the associated financially-material risks. The list of risks is long, and growing:

- Rising geopolitical tensions that increase business risk for U.S. companies in the region, increasing the likelihood of tariffs, sanctions up to and potentially including requiring Starbucks to pull out of the region entirely;
- Interference from the CCP, which has unilateral power to make or break politically favored or disfavored businesses in the country;
- Flagging consumer confidence amid Chinese economic downturn, which has the potential to significantly impact; and
- Sudden, increased competition from local brands, which often enjoy government-backed advantages and so do not compete on a level playing field.

Yet Starbucks has barely acknowledged these concerns.

Starbucks's shareholders deserve more. That's why Strive's Head of Corporate Governance, Justin Danhof, wrote to Starbucks last Wednesday to ask the company to assess and disclose its China-related financial risks.

“Starbucks’ China strategy appears to be a major gamble with a hostile partner,” one that “regularly props up local businesses over foreign companies,” Danhof told Semafor in an interview last week. This is unacceptable. Strive believes that China risk is investment risk. And investors deserve full transparency.

Until that happens, Strive will continue to engage with Starbucks and other companies exposed to China risk to promote such disclosures so that investors can assess these strategies and ensure these companies have best positioned themselves for long-term financial success.

Read Strive's letter to Starbucks here.

Exxon CEO Speaks On Harms Of Villainizing Oil And Gas Producers

“The solutions to climate change have been too focused on reducing supply,” Exxon Mobil Corp. CEO Darren Woods said in a speech last Wednesday at the Asia Pacific Economic Cooperation CEO Summit in San Francisco. “That’s a recipe, for human hardship and a poorer world.”

Woods maintained that Exxon wouldn’t follow European energy majors in reducing fossil fuel production and focusing on renewables, arguing that would only keep the developing world impoverished. Instead he advocated improving technologies like carbon capture, asking for taxpayer subsidies to help do it.

Woods’ pitch may have been self-interested, but he was right that the world is villainizing Big Oil; that’s showing up in its share price. US energy companies trade at a PE ratio of around 10, well below their 30-year average of 23.3. Energy has become the newest type of sin stock, and ESG-driven divestment is making the sector dirt cheap.

The gap between earnings and share price is especially glaring relative to tech, an investor darling—and a favorite of ESG funds because software doesn’t produce greenhouse gas emissions. From March 2019 to September 2023, US energy sector shares rose 142% while stock prices rose only 42%. In contrast, tech sector earnings rose 47% yet share prices spiked 125%.

We think the energy sector is due for significant multiple expansion as investors realize that the world will need fossil fuels for the foreseeable future. And ESG-inspired reductions in oil and gas exploration and production today will cost the world as the decade goes on. We think the coming decade of undersupply will raise oil prices, giving a further tailwind to the energy sector.

Belief in the green transition is a policy stance, not a valuation technique. As the world falls further and further behind in achieving the Paris Accords’ net zero emissions targets, it will become increasingly obvious that the energy sector offers investors superior risk-adjusted returns.

"Oil and gas companies reliably provide affordable products essential to modern life," Exxon's Woods told the crowd. He's right. And as it turns out, oil and gas companies may soon prove to provide financial outperformance as well.

For Stakeholder Capitalism Enthusiasts, Thanksgiving Is For The Birds

Just in time for the holiday, the nonprofit Mercy for Animals released its 2023 animal welfare scorecard, ranking corporations from Costco to Wendy's on their progress on cage-free eggs, treatment of poultry, and other goals. Many companies, it turns out, have adopted such policies, despite dramatically higher costs and lack of consumer demand. But why?

It's not that animal welfare activists have persuaded farmers that the costs are worth it. For years, nonprofits have demanded American farmers adopt expensive, animal-friendly farming practices, with little success. They then began pressuring customers and distributors—grocery stores and retailers and restaurants—to purchase poultry products only from farms that agreed to their demands. And when these efforts fell short, activists again upped the pressure by working with ESG-minded investment firms to file shareholder proposals pushing farmers, customers, and distributors to adopt such practices.

The demands are extensive. The Humane Society, for example, has a 116-page Animal Welfare Standards for Turkeys that requires, among many other things, that every farm (1) appoint an Animal Welfare Officer, (2) adopt a code of conduct requiring personnel "to handle the birds in a positive and compassionate manner at all times" on risk of termination, (3) develop a nutritional plan certified by a "qualified poultry nutritionist," and (4) provide turkeys with a remotely-monitored, temperature-controlled environment. These requirements far exceed legal requirements.

And the measures are expensive. Per one study, cage-free production requires "at least twice the capital of caged facilities" and "two to three times more labor." Another study by the Department of Agriculture estimated that an animal-welfare rule similar to The Humane Society's would cost organic farmers between $9.3 million and $14.6 million a year. And because shoppers are unwilling to pick up the tab, farmers and the companies they serve are expected to simply eat the costs.

Asking farmers to adopt these policies is one thing, but forcing them to do so via corporate shareholder activism is another. In 2023, The Humane Society took the latter approach, teaming up with the ESG investing firm Green Century Mutual Funds to file shareholder proposals pushing Applebee's, Dollar Tree, Dollar General, Nabisco, and more to use cage-free eggs. The Humane Society also filed proposals at General Mills, McDonald's, and Royal Caribbean Cruises to, for example, issue "action plans" and "improve the welfare of animals in its poultry supply." These proposals are then promoted by activist groups like As You Sow, which coordinate with financial managers like BlackRock to garner support. None of these proposals are designed to improve financial return. Yet many companies feel pressured to adopt at least some of the requested practices anyway.

The results are clear: the turkeys may be somewhat better off, but the shareholders—teachers with pensions and parents saving for a child's education—in the many companies that produce, distribute, and use poultry products are most certainly not. Here's hoping that by next Thanksgiving, these ESG activists will have flown the corporate coop.

U.S. CEOs Greet Xi Jinping With Standing Ovation, But Skepticism Remains

Chinese President Xi Jinping met with elite American business leaders following his meeting with President Biden, the Financial Times reported Wednesday.

Xi delivered his remarks at a dinner in San Francisco attended by about 300 executives, including Elon Musk of Tesla, Tim Cook of Apple, and Albert Bourla of Pfizer. Several Wall Street executives were also in attendance, including BlackRock's Larry Fink, who has enjoyed a close relationship with the Chinese leader and was seated at President Xi's table for dinner.

During his remarks, Xi claimed, "China is ready to be a partner and friend of the U.S." and reminded the audience that "China is both a super-large economy and a super-large market" that presents "a huge opportunity" for their companies to tap.

But many business leaders remain skeptical. A former executive from the U.S. Chamber of Commerce, for example, expressed concerns that Xi was courting the business community to help manage ties with Washington, rather than to promote trade. "[The b]ottom line is that American business leaders don't want to be caught in a game of chess between China and the U.S. governments," he told the Financial Times. Another attendee had similar concerns: “[Xi] offered no hints of concessions to business or even interest in more investment in the Chinese economy,” a senior American business executive told the Wall Street Journal. “The speech was propaganda at its finest.”

Investors appear skeptical as well. Earlier in the day, the Federal Thrift board—which heads the $800 billion pension fund for federal employees—unanimously voted to remove China from the benchmark for their international fund. Shareholders in U.S. companies might similarly ask "whether cozying up to Mr. Xi really serves their interests," the Wall Street Journal opines.

The dinner also comes as foreign companies increasingly recognize that the Chinese government has been slowly squeezing them out in favor of local competitors, and that recent crackdowns on foreign businesses make investment in the region riskier than ever. The meal may have been well prepared, but the remarks appear to have been only half-baked.

Coal Spin-Offs Harm Investors Without Helping Environment

Despite the ESG movement's claims, "coal may not be the great valuation drag after all," The Globe and Mail reported last week. In fact, many coal spin-offs have greatly outperformed the larger energy and mining companies they were spun off from, suggesting that shedding coal in the name of sustainability did not lead to better returns.

The piece chronicles the rise of ESG investing over the past several years, including its central thesis that companies that reduce their destructive impact on the planet would be rewarded by greater financial return. Following this trend, many companies tried to "transform DirtyCo into CleanCo" by spinning off their least-green business lines into separate entities. According to the outlet, the move was lauded by the likes of investors like "BlackRock chairman Larry Fink" who "had warned that climate change was . . . an existential threat to Earth itself."

Over time, however, people began to realize that these spin-offs "did absolutely nothing to clean up the planet" since the new, privately-held entities continued to mine and burn coal with even less public scrutiny.

And the results were equally bad from a financial perspective:

> Investors who endorsed ditching their companies’ hydrocarbon assets often watched those same assets turn into stock market darlings. Thungela soared more than 1,300 per cent on the Johannesburg exchange in the year after Anglo American spun it off and generated enormous amounts of cash to finance fat dividend payments.

Despite these developments, the Canadian mining giant Teck is planning to sell its coal division, which represents 60% of the company's revenue and 75% of its profits. Whether the move helps Teck's long-term growth prospects remains to be seen.

Corporate Spending on ESG Services Expected to Balloon in Coming Years

The lawyers always win. But sometimes the consultants, auditors, and software companies win too.

A new report out last week estimates that the market for ESG reporting software will balloon to $2.25 billion by 2031. That's for reporting software alone. ESG and sustainability consulting services are expected to grow from $11.5 billion to $48 billion by 2028. And ESG assurance services—essentially, third-party audits of ESG and sustainability reports increasingly required by regulators—will likely grow from $1.5 billion to around $6 billion over the same timeframe. For comparison, the total global market for business services related to occupational health and safety is just $10 billion, and the economy-wide compliance costs of financial reporting following the passage of the Sarbanes-Oxley Act in 2002 was estimated to be around $5.5 billion.

Notably, the analyst's ESG-related estimates do not include legal costs, including increased litigation risk as companies face scrutiny from both sides of the stakeholder capitalism debate. Nor do these reporting-related costs include the costs of the underlying ESG initiatives themselves, including the billions of dollars corporate America has poured into initiatives fighting climate change, creating diversity and inclusion programs, and pursuing other political and charitable causes.

Proxy Advisors' Material Errors Go Unchecked

A new study from the American Council for Capital Formation concludes that Glass Lewis and Institutional Shareholder Services (ISS) make significant errors in their voting recommendations to investors with little oversight.

The study reports such errors are up 28% from 2021 levels. The errors include recommending that shareholders vote against an executive pay proposal based on a mathematical miscalculation of the value of certain stock awards and recommending shareholders oust a director from a company board based on a misunderstanding of Indiana corporate law regarding the procedures for amending company bylaws. These errors were identified by the companies themselves, but ISS and Glass Lewis refused to change their recommendations.

This year, the increase in errors is cause for even greater concern, as the Big Three have each handed ISS and Glass Lewis more responsibility to vote their clients' shares via so-called "voting choice" programs, as their own in-house voting practices have come under scrutiny. As the Wall Street Journal reported in July, "[a]sset managers say they’re giving investors new proxy vote options," but, generally speaking, the only choice is to select from "pre-selected voting policies crafted by . . . Glass Lewis and ISS, both of which support ESG investing."

Now, these voting programs have come under additional criticism: not only do these "voting choice" policies require investors to choose between ESG Option 1 and ESG Option 2, but it appears they are riddled with factual inaccuracies as well.

An Eye on Energy

The United States' Growing Role In The Natural Gas Market

In the past, Europe’s ability to meet its winter energy demand depended on continued supplies from Russia, mild temperatures, and liquefied natural gas (LNG) imports. Now that Europe has largely banned Russian fossil fuel imports following its invasion of Ukraine in February 2022, U.S. LNG imports have played an even more prominent role.

The U.S. shale revolution has had many impacts across almost every traded energy commodity, and our role as a leading exporter of LNG is a stabilizing force in the global market. According to the Energy Information Administration, U.S. exports of LNG averaged 10.6 billion cubic feet per day in 2022, up 9% from 2021. The increase was driven by strong LNG demand in Europe and expanded U.S. liquefaction capacity. As a result, U.S. LNG exports to Europe increased 141% from 2021 levels. These deliveries have allowed Europe to mostly replenish its inventories. These existing inventories, coupled with expanded global LNG export and import capacity, should enable enough natural gas for Europe to meet demand in the 2023–24 winter season (November–March).

But risks remain. As Europe has recently learned, the global energy picture is connected to economic and political events. An unexpected surge in demand, extreme weather event, or significant global supply disruption would cause the LNG market to become volatile.

Despite increased reserves, Europe remains vulnerable to a disruption because their stockpiles may be unable to cover gas demand for the entire heating season. Accordingly, supply risks to both the price and global natural gas balances could significantly impact Europe. Such risks include:

- an increased pace of China’s natural gas demand recovery,
- severe cold weather over an extended period of time,
- an unplanned supply disruption or production freeze-off from a major natural gas supplier,
- a steep reduction in pipeline exports from Russia or additional physical risks to gas supplies associated with the war in the Ukraine,
- a strike similar to the one that occurred at the Chevron LNG facility in Australia, or
- an escalation of the war in Gaza across the Middle East that affects global supplies.

While it's impossible to quantify how any particular risk, alone or in combination, would affect Europe's energy position in any given scenario, one thing is certain: any of the above occurrences would change the global balance by creating supply shortages, thereby placing upward pressure to the spot price of LNG.

In this environment, U.S. LNG is a stabilizing force. As heightened geopolitical tensions continue to fragment international commodity markets and force them to evolve, the U.S. LNG industry will seek new markets and remain a dependable supplier of natural gas to the global economy.

The Best of the Rest

Additional stories about ESG investing, company happenings, and more.

- China circumventing U.S. semiconductor regulations; "importers are often able to purchase the equipment if they claim it is being used on an older production line, and . . . it is difficult to verify the equipment is not being used to produce more advanced chips," the report concludes.
- SEC releases enforcement report; summarizes ESG-related enforcement actions against Goldman Sachs and Deutsche Bank.
- Wall Street's ESG craze is fading; investors pulled $14 billion from sustainable funds as interest rates have slammed green energy stocks and investors realize that stakeholder capitalism is not a path to riches.
- ESG comes to the fore in Louisiana treasurer election; voters to decide whether pension funds should focus on ESG policies or financial security.
- U.S. borrowers retreat from sustainability-linked loans; required ESG targets are getting "harder and harder" to meet and pose reputational risks.
- Congressman Patrick McHenry discusses ESG legislation; says pending bills promoting financially-focused investing practices could be appended to other bills to ensure they make their way through.
- Companies increasingly tie executive pay to ESG but refuse to tell shareholders what ESG metrics, exactly, their executives are supposed to meet.

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Strive is one of the fastest growing asset management firms. Our mission is to maximize value for our clients by leading companies to focus on excellence. **Click here** to learn more.

What Makes Strive Different?
While many asset managers push companies to focus on other stakeholders such as employees, suppliers, the environment and society at large, we live by a strict commitment to shareholder primacy — the belief that **the purpose of a for-profit corporation is to maximize long-run value for investors. Click here** to learn why shareholder primacy is so important.

How Does Strive Maximize Value?
Our corporate governance team engages with the companies in which our clients are invested to advocate for the pursuit of excellence in corporate America. We are aggressively apolitical when it comes to utilizing our corporate governance tools and demand that companies focus exclusively on delivering long-term financial value for investors. The corporate governance team also determines how to cast our shareholder votes at annual meetings and special elections, evaluating each proposal through the lens of maximizing financial return.

Our research team conducts deep analysis of macro economic trends, market developments, and industry- and company-specific metrics to identify potential risks and opportunities for our clients. We then incorporate the results of this research into our engagement and voting strategy, and share it with our clients in the form of white papers and market research reports so they can make the most educated investment decisions possible.