# POSITIVE CHANGE
# Q2 INVESTMENT UPDATE

Investment specialist Rosie Rankin and investment manager Josephine Bentley give an update on the Positive Change strategy covering Q2 2023.



**Rosie Rankin (RR)**: Welcome. My name is Rosie Rankin, and I'm an investment specialist. I'm delighted to be joined today by Josie Bentley, who is an investment manager. And we both work on Positive Change, a global equity strategy with two equally important objectives: to generate attractive investment returns and to contribute towards a more sustainable and inclusive world.

This quarter, we're going to talk about the transactions within the portfolio. There has been one new buy and three complete sales. So firstly, let's start off with the new buy Daikin. Now, Josie, I'm intrigued. Daikin is an air conditioning company. Why on earth is air conditioning relevant for Positive Change?

**Josephine Bentley (JB)**: Thank you, Rosie. It may seem counterintuitive for a sustainable fund to invest in air conditioning and in an ideal world, all our time spent in an indoor built environment would be in new buildings with state-of-the-art insulation and design features that mean that there is a comfortable indoor temperature with minimal mechanical intervention. That's the ideal and we will continue to look for companies in this theme of sustainable buildings.

In the meantime, we have two key issues. First, we have the existing building stock. It's impractical. It's not financially sensible or energy efficient to raze the world's buildings to the ground and build them up again with more environmental credentials. Secondly, the climate is changing. The World Meteorological Organization found the last eight years to be the warmest on record, and there are important economic regions like India and Indonesia with growing populations and already unmet cooling need and who are more vulnerable to extreme heat, extreme heat waves.

So, what is a scalable, practical and globally accessible solution to these challenges? Air conditioning. And so I think air conditioning is necessary for climate adaptation.

**RR**: So is it all about climate adaptation then?

**JB**: No. And this is also important because of an economic growth case. So you'll often find that adoption of air conditioning is tightly linked to economic growth.

For example, we can look back at China and see a phenomenal adoption of air conditioning units within households from around the mid-nineties to 2010. And that was a time of significant increasing prosperity for China.

And air conditioning also has a strong social contribution. Having a comfortable indoor environment is so important for maintaining health outcomes and also increasing the productive hours of the day. And you can see that the founder of modern Singapore, Lee Kuan Yew, used to say that air conditioning was one of the most important inventions and made development possible in the tropics.

So, this is fundamentally an investment that is an optimistic take on economic growth and rising living standards. But at the same time, we appreciate that with the climate changing, air conditioning may move from being an aspirational good to more of a necessity.

**RR**: You've made a really compelling case for why an air conditioning company merits a place in the portfolio. Why Daikin? What's special about Daikin?

**JB**: So Daikin is the global leader in heating, air conditioning and ventilation equipment. And it was founded in Japan, 100 years ago. So it's managed to create a globally diversified and very significant scale of air conditioning equipment. And what's remarkable for a company of this size and heritage is that it's also had a real track record of environmental leadership and innovation.

So if we step back, air conditioning is often seen as a bad thing for the environment, for two main reasons. The first is the energy in use. And the second is the refrigerant. So that's the working fluid in an air conditioning system. And if that refrigerant chemical were leaked, it can cause ozone depletion multiples of times more than carbon dioxide.

So those are the two key challenges. And you can see over decades Daikin working to mitigate these challenges. So, on the energy efficiency side, Daikin has made the use of inverters in air conditioning really widespread. Now, inverters mean that for air conditioning you don't need to keep stopping and starting the equipment. You can keep the motor usage quite stable in the background. That's much more energy efficient. And the second point on the refrigerant usage is they've pioneered the use of this new, much less environmentally damaging refrigerant called R32. And unusually, Daikin's actually released its patents for R32 to encourage the whole industry to move towards this more environmentally-friendly refrigerant.

So what's special about Daikin is this track record of innovation. And I think what will allow Daikin to continue to do that is its vertical integration. So, Daikin not only makes the equipment, it also makes the refrigerant. That's quite unusual in this industry. And we find that Daikin is able to make incremental innovations because it's able to put this equipment and the refrigerant together and try and optimize for the whole system in a way that's quite unique.

And this is not mission accomplished. We would expect a new generation of refrigerants and we would expect Daikin to make ever more environmentally and energy efficient equipment. But for now, Daikin is out there as a scalable and very significant high-quality manufacturer that should have the influence to keep moving the industry forward.

**RR**: And I noticed you mentioned heating there. Could you elaborate a little bit more on that aspect of Daikin's business, please?

**JB**: Yes, of course. So heat pumps, which are a known alternative to fossil fuel-based boilers, constitute just less than 10 per cent of Daikin's sales at the moment. But they are a growing part of the investment case and also have a significant environmental benefit. And this is particularly important in regions like Europe, which have a strong regulatory tailwind for heat pumps.
And also growing awareness around the public for heat pumps.

Now, what's crucial for heat pumps, and that push back that always comes through, is they've just got to work. It's got to work. It's great having this alternative to a boiler, but once I install it in my home, will it function? And Daikin is obsessed with coming up with locally relevant products and optimizing its range for particular countries and particular environments.

So, you'll find with Daikin heat pumps, some of the specifications are very far ahead of the competition. For example, the heat pump works very well in lower ambient temperatures, and it also won't need certain extras like a backup electric heater, which some inferior models might use.

But I think it's important that we don't think about heating and cooling as two separate markets. I've followed this industry for a while now and, during the course of my research, spent some time at a trade show in Atlanta, Georgia, to really get my ear to the ground and find out what was going on. And I think what's happening is, as both heating and cooling systems electrify, those markets are converging. I think in future you will have one technician coming to a household who can advise on both heating and cooling and a superior air-to-water heat pump now will already be able to both heat and cool the home.

And this puts Daikin in a strong position because it has an excellent and locally relevant product line up across heating and cooling. And I strongly think that that is the way to continue to take share in this market.

**RR**: It's absolutely fascinating. Josie, but I'm conscious that we should also talk about the companies which have left the portfolio over the last few months.

So, we have three sales. We have Teladoc and Peloton and NIBE. I wondered if you could just briefly outline the rationale for those sales, please?

**JB**: Yes, of course. Why don't we start with NIBE? Given we just spoke about Daikin. So NIBE has been held in the portfolio since inception. So, since the beginning of 2017, a very long-standing holding. And it's a Swedish maker of heat pumps, as well as stoves and some electrical components. It's done very well since we've held it. In fact, it's been the great heat pump success story. But along with that, success has come an increase in the valuation premium. And actually, alongside our risk team internally, we found out that NIBE had, over the course of our holding period, delivered over a five times investment return for clients, which is good news, of course. But we found that 57 per cent of that upside had come from a change in the valuation and only 43 per cent had come from the actual growing business fundamentals.

So, we looked at the heat pump landscape now with increasing competition and we measured that against NIBE's now quite demanding valuation. And we felt that at this point NIBE was unlikely to meet our return hurdle.

So, though we have continuing excitement for heat pump adoption from both the investment and the impact side, for this stock at this time, we felt it was time to move on.

**RR**: That's very understandable. So then in terms of Teladoc and Peloton?

**JB**: Teladoc and Peloton are different stories. So Teladoc, we bought in October 2019. At the time, Teladoc was the largest telemedicine company in North America, and we were excited about this position to really increase access to healthcare and transform some of the inefficiencies that exist in the healthcare system.

And what changed really was the pandemic because first of all, we saw a wave of capital come in to support other telemedicine companies. And actually, some of this competition we worked out was quite irrational and changing that competitive dynamic. We did a lot of research into these newcomers that were coming into the market from tech companies to healthcare incumbents. We engaged with many of them directly, and we also set out our investigative researcher to go in and find out what was really happening on the ground.

And the result of this research was that though Teladoc probably did still have the best business model, it was going to be tricky for it to continue to capture great growth with this other competition.

At the same time, I think we overestimated the pace of adoption after the pandemic. Now, we never expected the remote telemedicine market to keep growing at the same level that it did through the pandemic. But we expected there to be a level of willingness there that doesn't seem to have transpired. Old habits die hard, and what we've really learned from the Teladoc example is that the healthcare system has so many stakeholders and so many different moving parts that it's quite difficult to estimate the probability of success for a new entrant.

So, with that research around that competition, and also the maybe waning adoption, we decided to sell out of Teladoc.

Peloton is somewhat of a similar story. So, this is a stock that we started investing in in March 2021. And at the time we were very excited for the increased adoption of its at-home fitness equipment, its connected fitness. We thought it could broaden access to the fitness market over time, as well as disrupting the existing gym market with its state-of-the-art equipment and brilliant classes. And on the impact side, we recognized the importance of fitness for a range of health outcomes. And we understood from the company that in time, the prices for its products would come down and therefore accessibility would be wider for its offering.

When the tide went out for at-home fitness equipment after the pandemic, we recognized that Peloton had more operational issues than we could have diagnosed at the time of purchase, such as an inefficient supply chain and other operational niggles. So, in 2022 there was a management change where the founders stepped back and Barry McCarthy, who we knew from his time as

CFO of Spotify, came in and tried to remedy some of the issues that had been laid out.

And as long-term patient shareholders, we wanted to give the new management team time, and we laid out milestones that we wanted to see from the company to help support Peloton and put it on a better footing for success. And one of those key milestones was really reducing the cash burn that started to come about at Peloton. We were encouraged that quarter on quarter that financial discipline was coming through, but at the same time, the macroeconomic environment had really changed, and access to funding was going to be much more challenging for a company like Peloton.

And so, if you think about trying to move different levers for growth in your business, at the same time as having limited financial flexibility, this was going to be a much longer turn around than we had initially expected, even for a management team that was moving in the right direction. So again, while we were patient shareholders, we just thought the probability of success for Peloton at this time was not high enough to justify a position in the portfolio. So we decided to move on and fund ideas where we had better conviction.

**RR**: Thank you. I'd like to finish, if I may, just about asking about what's in the pipeline in terms of research. I know the team have been out and about a lot. Could you share some of the current work?

**JB**: Of course. It's been a very busy time for the team. We've been rushed off our feet and I think it's particularly good that we're able to go and meet companies in person again after two years of the pandemic, there still feels like there's quite a backlog, not only in deepening the relationships with our existing holdings, but also in going out and trying to find new ideas.

I've just come back from seeing 18 companies in healthcare in California, particularly to understand the future of genomics. My Impact colleague continues to deepen her research in the generics industry, very important industry for access to healthcare, and has been doing further work in conferences there to understand the landscape of potential investment opportunities.

Another investment colleague is just back from Japan. She spent two weeks there and is currently writing up her prospects on many different themes from MedTech to housing. And again an impact colleague is just back from Japan – no he’s just back from China – where he spent a week looking at renewable energy companies, sustainable transport companies and battery companies as well.

So, it's really exciting to see the breadth of themes and breadth of ideas coming through, both in terms of the geographies covered, but also stage of companies and the industries. So, it's a very exciting time to be topping up that investment funnel and I hope we'll have more news to report on soon.

**RR**: That sounds like the perfect optimistic note to finish our discussion on. Josie, thank you so much for your time and thank you so much to everyone who has taken time out of their day to watch us. We very much appreciate your support. Thank you.

**Annual past performance to 30 June each year (net %)**

| | 2019 | 2020 | 2021 | 2022 | 2023 |
|---|---|---|---|---|---|
| Positive Change Composite | 1.6 | 47.6 | 65.7 | -38.4 | 24.3 |
| MSCI ACWI ex US | 6.3 | 2.6 | 39.9 | -15.4 | 17.1 |

**Annualised returns to 30 June 2023 (net %)**

| | 1 year | 5 years | Since inception* p.a. |
|---|---|---|---|
| Positive Change Composite | 24.3 | 13.7 | 19.3 |
| MSCI ACWI ex US | 17.1 | 8.6 | 9.9 |

*Inception date: 3 January 2017

Source: Baillie Gifford & Co and MSCI. USD. Returns have been calculated by reducing the gross return by the highest annual management fee for the composite.
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