# It's not easy being green

## Analysing corporate treatment of carbon-intensive activities

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In response to the climate crisis the economy shows clear signs of shifting from "brown" to "green". Driving this secular change, companies lower their carbon footprint by winding down or divesting carbon-intensive activities. These decarbonisation strategies can have meaningful — and sometimes contradictory — effects on companies' sustainability credentials and financial strength. For a complete understanding of such corporate activity a new set of questions must be answered.

## Key points

- As opportunities rooted in the green economy open up across the corporate and banking sectors, companies are recognising the benefits of being seen as a decarbonisation leader. In addition to pursuing strong growth opportunities within the green economy, companies benefit from being identified as a leader in the fight against climate change.
- Pioneers are far more likely to be screened into the portfolios of investors seeking to reinforce their own sustainability credentials.
- However, while the motives for companies are clear, for investors, accurately assessing the real, net impact of a company's decarbonisation strategy is far from straightforward.

## Shades of complexity: the different paths from brown to green

In the context of sustainability, analysing a company's carbon footprint and intensity is the most common way to assess a company's decarbonisation trajectory. There are multiple ways to improve these metrics: for example, companies can shift from using fossil fuels to renewable energy sources, or they can reduce the carbon content of manufacturing inputs such as steel and building materials. However, the focus of the framework we have created is on two further, related ways of decarbonising: either winding down or divesting/demerging carbon-intensive activities rooted in the old 'brown' economy.[1]

Such a framework is needed because assessing the financial and sustainable impact of a company either winding down or divesting itself of a carbon-intensive activity is complex. For example, a company can quickly cut its carbon footprint via a divestment, but if that 'brown' activity goes on to thrive in the hands of its new owners the environment does not benefit in any way.

Optically the divestment appears quite positive, at least for the individual company's carbon footprint. However, by delivering the carbon-intensive activity into the hands of a proponent, the decision has a net negative impact on the decarbonisation of the planet as a whole. As such, before we reward a company for reducing its carbon footprint through the divestment of polluting assets, it's important to know where those assets end up. From a climate change point of view, we want to understand what an action means for the overall decarbonisation of the economy compared to, say, simply winding down that activity.

Then there is the financial assessment. As investors we are compelled to determine the materiality of any financial impact divestment of carbon-intensive activities will have. We can then compare this to the impact of winding them down. In some cases divestment could reduce the carbon intensity of the company's operations and benefit the environment but be detrimental to its financial profile or vice versa.

Our Fixed Income team decided to address the need to assess the impact a company's treatment of carbon-intensive activity has on both its sustainability and financial credentials. A working group of financial analysts and sustainability experts collaborated to design an analytical framework. A summary of the framework is below.

[1] For simplicity's sake, we will refer to divestments and demergers in the rest of this paper using the single term 'divestments' as the key concept of withdrawing from the carbon-intensive activity is common to both. We will separate the two concepts when necessary as part of the analysis that the framework describes.

## The Framework

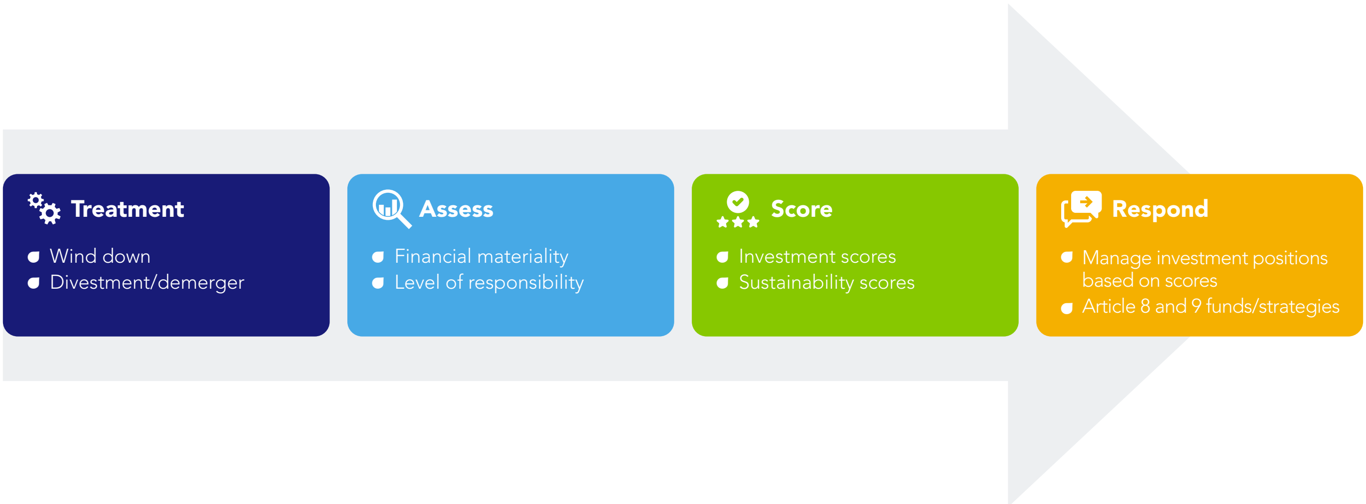
### To own or not to own, that is the question

As a first step in the analysis we need to ask: is the company winding down or divesting the carbon-intensive activity? Once we have the answer, we can run through the framework to understand the benefits and drawbacks of the chosen approach to determine investment and sustainability scores. These can then be used to determine portfolio composition. In essence, we aim to determine two things:

1. **Financial impact:** how material is the net effect of the wind down or divestment to the financial strength of the company?
2. **Sustainability impact:** how responsible is that treatment of the carbon-intensive activity both in the context of the company itself and in the wider economy?

Once we have assessed the direction and materiality of both the financial and sustainable impacts, we can then adjust the investment and sustainability scores for the relevant company. In line with our process-driven approach to investing, if the analysts and sustainability experts adjust their scores, portfolio managers implement trades to reflect these updated views.

**Figure 1:** Summarised assessment of process for analysing wind downs and divestments




Source: Federated Hermes, as at June 2021.

### Impact analyses for wind down versus divestment

#### 1. Wind down

In a wind-down scenario the parent company, seeking to reduce its carbon footprint, opts for a gradual, controlled reduction of a particular brown activity. In this case, the carbon-intensive activity remains on the balance sheet. Figure 2 below provides a summary of the positive and negative financial and sustainability impacts of a wind down.

**Figure 2:** Framework of impacts for consideration in a wind down

| Wind down | Positive | Negative |
|---|---|---|
| Financial | • Re-allocation of opex/capex to growth<br>• Retains benefits of positive cashflows<br>• Market may reward company for decarbonisation efforts | • Possible moribund activity stays on B/S<br>• Operation could drain value<br>• Investors ‘screen out’ company because it retains ‘brown’ activity<br>• Risks causing an impairment change |
| Sustainable | • Actively reducing GHG emissions<br>• Supports decarbonisation trend<br>• Opportunity for positive social impact through job retention/retraining | • GHG emissions still being produced<br>• Possible negative social implications if action generates significant job losses |

Source: Federated Hermes, as at June 2021.

**2. Divestment**

In a divestment scenario the parent company removes the carbon-intensive activity from its balance sheet through a sale or demerger. The company abdicates responsibility for the management of the carbon-intensive activity and it is no longer recognised in its financial statements. The potential positive and negative financial and sustainability impacts of divestment are therefore different from a wind down, as set out in Figure 3.

**Figure 3:** Framework of impacts for consideration in a divestment

| Divestment/demerger | Positive | Negative |
|---|---|---|
| Financial | • Proceeds in consideration of a sale<br>• Removal of moribund/slow-growth business from the balance sheet<br>• Could be positive for WACC<br>• May reduce risk of being 'screened out' with departure of the activity | • Potential loss of mature, but cash-generative activity<br>• Risk that legacy environmental and other liabilities remain with company |
| Sustainable | • Immediate, positive impact on carbon footprint of the company<br>• Potentially avoids negative social impact of job losses<br>• Clean break may allow management to focus on strategic 'green' activities | • Carbon-intensive activity ports to an entity that may perpetuate/accelerate the activity<br>• Leads to job losses with no social safety put in place<br>• Risk of reduced governance/responsible oversight under a new regime |

Source: Federated Hermes, as at June 2021.

We have written this framework because, as mentioned at the outset, assessing the net effect of the treatment of a carbon-intensive activity in the context of a decarbonising company is complex. Second-order effects on the sustainable and fundamental character of the parent company must be considered. For example, a divestment might optically augment the parent company's sustainable scores and be more financially attractive than a wind down at face value. However, if the 'brown' activity continues to operate unbridled in the hands of new owners, the transaction has done nothing to address the overall effect on climate change. This can have negative indirect consequences for the investment, and the sustainability and financial scores should reflect that.

## A holistic approach that respects the principles of the investment process

For the fundamental assessment, we follow a pretty well-trodden path of financial analysis. As described above, we determine the impact of the divestment or wind down on transition risks, cashflows, debt and enterprise value, scoring accordingly. This helps us determine how much volatility contribution we can take in the name. The net effect will influence both Credit and ESG scores.

For the sustainability assessment, it is not just a matter of subtracting the 'brown' activity's carbon emissions from that of the parent company. Instead, we aim to determine how responsible the wind down or divestment is in the context of the wider economy. We do this by analysing the ultimate impact on society and the environment of the parent company's chosen course of action. We then fold that conclusion into the context of the parent company's other sustainability activities, assessing the impacts on a holistic basis and with a forward-looking view. This analysis paints a much more complete picture that conveys the earnestness with which the company is decarbonising and thus allows us to assign more accurate sustainability scores.

Overall, the framework reflects a holistic approach that takes into account the wider impact of a company's strategy for decarbonising its assets. At the same time, it fully respects the principles of the investment process.

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