ENGAGEMENT CASE STUDY:

Enel

Federated Hermes SDG Engagement High Yield Credit Fund, Q3 2020

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Enel Group, an Italian energy company, operates a global portfolio of renewable, nuclear and thermal generation plants across 48 countries and employs over 68,000 people. Founded as a public utility in 1962, Enel became a privately owned company in 1992 and is now one of the largest European utilities.[1] Enel reduced its dependency on hydrocarbons in the aftermath of the 1973 oil crisis and produced the world's first grid-connected solar installation and Italy's first wind farm.[2] Today, more than half of its global energy generation comes from zero-emission sources.[3]

Investment case

We see Enel as a global leader in decarbonisation within the utility industry. After a strategic shift in 2015, Enel continues to decarbonise its electricity portfolio – which was previously one of the highest-emitting electricity portfolios in Europe – and has a 31.4 gigawatts (GW) renewable investment pipeline planned over the next five years.[4]

Enel has a lower credit rating than its main competitors, which can be explained by the fact that Italy – which has a Baa3/BBB credit rating – owns 23.5% of the firm. However, the company has the strongest balance sheet among its peer group of high-quality, investment-grade, integrated European utility companies. Although Enel has increased its capital expenditure, we expect its economic net debt to EBITDA to stay around 3x from 2020-2025 (compared to 4-4.5x for some of its higher-rated key competitors).

Enel's bonds remain vulnerable to macroeconomic volatility in Italy. We seek to benefit from the premium this offers – which we believe does not reflect the company's positive fundamentals – while also actively supporting electricity decarbonisation through investing in the firm's debt securities. We value the alignment of Enel's financial policy and sustainability goals, demonstrated by its issuance of green bonds and credit facilities and bonds that are linked to the Sustainable Development Goals (SDGs). Enel has also connected 30% of its management's short-term remuneration – and 25% of its long-term remuneration – to sustainability objectives.

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Engagement context

The utilities industry is at a critical juncture. Climate-related regulatory pressures and coronavirus-induced shifts in global energy demand has resulted in energy-source cost and price volatility and considerable uncertainty about future demand. Electricity production makes up the second-largest share of global emissions[5] and the industry will be affected by the Paris Agreement, the revised renewables and energy efficiency directives in the EU Green Deal[6] and other climate-related regulations. These regulations mean there will likely be new or increased costs relating to intensive greenhouse-gas emitting activities in and beyond the utilities sector.

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[1] 'Italy's Enel tops list of 20 largest European utilities by market cap', published by S&P Global Market Intelligence in June 2019.
[2] 'Our Story', published by Enel Group.
[3] 'Consolidated Annual Report 2019', published by Enel in March 2020.
[4] 'Enel Capital Markets Day', published by Enel on 26 November 2019.
[5] 'Sources of greenhouse gas emissions', published by the EPA in 2018.
[6] 'Review of renewables and energy efficiency directives' published by European Commission in August 2020.

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In addition to helping tackle the climate crisis, decarbonising utility operations and value chains is also vital if firms are to be cost competitive. Technological disruption to the energy market – relating to generation, transmission, storage and demand management – is another reason to transition to cleaner alternatives. Wind energy and solar photovoltaics prices have fallen by a respective 70% and 89% over the last decade[7] and could make up almost half of the world's electricity in 2050.[8]

The building and operating costs associated with these energy sources are often lower than for comparable fossil-fuel projects and intermittency problems will be reduced as technology improves. Indeed, Bloomberg forecasts that in 2050, gas-fired power may no longer make up the core of electricity generation and could simply provide supply-system back-up and flexible capacity in the case of higher demand.[9]

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Enel has committed to ending its coal operations by 2030.[10] While the industry is moving in a similar direction, decommissioning coal plants poses a potentially costly challenge to the capital that is set aside for ambitious growth projects and the transition towards renewables – particularly when the decommissioning occurs well before the end of an asset's working life. Increased regulation and recent write-downs in coal assets mean that decommissioning reserve funds may be unable to cover unexpected retirement costs. Companies such as Enel must anticipate and incorporate these costs to ensure they do not disrupt finances over the next decade.

> **...there is a renewed focus on workforce inequalities which persist across gender, ethnic and racial contexts.**

For large employers around the world, social issues and challenges have also rapidly come to the fore this year. Besides the extraordinary steps many companies have taken to safeguard their employees' safety and livelihoods, there is a renewed focus on workforce inequalities which persist across gender, ethnic and racial contexts. Uncomfortable gaps in workforce, management and board equality have not gone unnoticed by investors and societal stakeholders. Companies, regardless of size, must consider what is required to create more inclusive cultures and workforces. This may include long-term efforts to reduce and eliminate pay gaps, decrease diversity shortfalls in middle and senior management teams and adopt diversity practices in recruitment, talent development and retention. Although this can mitigate human capital management, brand and reputational risks, a broad base of research also indicates that more diverse firms tend to outperform their peers.[11,12,13]

> **Companies, regardless of size, must consider what is required to create more inclusive cultures and workforces.**

[7] Levelized cost of energy analysis', published by Lazard in November 2019.
[8] 'New Energy Outlook 2019', published by Bloomberg on 18 June 2019.
[9] Ibid
[10] 'Enel eyes faster coal exit as worsening economics "here to stay"', published by S&P Global in June 2020.
[11] 'How Diverse Leadership Teams Boost Innovation', published by Boston Consulting Group in 2018
[12] 'Delivering Through Diversity', published by McKinsey & Company in 2018.
[13] 'When Gender Diversity Makes Firms More Productive', published by Harvard Business Review in February 2019

SDG-focused engagement

Decarbonising global power systems
SDG 7

As new technology is introduced, the renewable energy landscape continues to evolve at pace. These energy sources have, historically, been limited by intermittency and high up-front costs. Advances and reduced costs in battery storage capacity, combined with the use of artificial intelligence to ensure renewables are self-optimising, are driving greater efficiency and improved cost competition with traditional fossil-fuel generating options. Transitioning from legacy, high-carbon generating assets is critical if firms are to maintain and improve competitiveness in markets with shifting generation costs.

Expanding a highly competitive renewables portfolio

In 2019, Enel's renewable energy assets accounted for 43.4% of its net electricity generation.[14] The company has announced plans to continue to grow its renewable energy capacity and has dedicated €12.5bn to the construction and maintenance of plants. Renewable generating capacity is expected to reach 60GW by 2022. We will engage with the company to understand the structure of this investment and how it plans to improve the competitiveness of its current renewable assets.

Addressing climate-related transition risk in thermal generating assets
SDGs 8 & 13

Power plants require large amounts of capital for construction and decommissioning. These costs must be considered when funding new projects to ensure any utility remains in a strong financial position over the long term. As the landscape for coal changes amid increased global regulatory burdens and the devaluation of coal assets, owners of coal-fired plants must carefully reassess capital allocation. This will help them cover decommissioning costs without risking the progress of other crucial commercial objectives, many of which are tied to a successful transition to the use of low- and zero-carbon generating and storage assets.

Clarifying capital allocation

Enel continues to transition away from thermal generating operations and towards low-carbon alternatives, and has committed to exiting its coal operations by 2030. Most of these coal assets lie in Italy, Spain and Portugal, leaving the remaining active plants at risk in light of the new climate regulations in the European Union. Considering these regulations and the worsening economics for coal power – the company wrote down more than €4bn-worth of coal assets in 2019[15] – Enel is accelerating plans to decommission several plants in Europe and Latin America. We recognise the cost considerations that the company must take and will engage with the company to understand how this will affect its plans for constructing and operating renewable energy assets.

The role of large global employers in fostering societal diversity
SDGs 5 & 10

Global utility firms like Enel have sizeable workforces in developed and developing countries. Large employers of this nature have an opportunity to positively impact local societies through fair, reasonably remunerated and secure employment. Reducing workforce inequalities has also become an increasing imperative. The Black Lives Matter movement has expanded far beyond the US, bringing into sharp focus the inequities suffered by minority groups. The Energy & Utilities Skills Partnership has highlighted the need for improvement in the UK utilities sector. Black, Asian and Middle Eastern employees represent just 5% of the utilities workforce in the UK, compared to an average of 12% across all sectors.[16] Companies that embrace necessary change and introduce initiatives to improve diversity also become more attractive employers of choice. This can drive productivity, retention, job satisfaction and create a more resilient and effective internal culture.

Making workforce diversity a source of competitive strength

Since announcing a global diversity and inclusion policy in 2015, Enel has advanced its objective to create a fair and accepting environment. This involved setting objectives to ensure equal gender representation by 2021 and committing to the Women's Empowerment Principles that are promoted by UN Global Compact. We believe that Enel leads its industry peers and think it can continue to do so by increasing its focus on minority group representation and greater gender equality. This will not only provide a valuable social licence to win entry into communities of operation, but may also improve productivity, reputation and have a positive impact on local societies.

[14] 'Consolidated Annual Report 2019', published by Enel on 19 March 2020.
[15] 'Enel eyes faster coal exit as worsening economics "here to stay"', published by S&P Global Market Intelligence on 11 June 2020.
[16] 'Workforce Renewal and Skills Strategy 2020–2025', published by Energy & Utilities Skills Partnership in June 2020.

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