On the Hunt Power Companies Grapple With Ever-Expanding ESG Issues

In theory, the term ESG refers to a fairly clear-cut set of issues that businesses need to manage.

Companies are scored on their direct and indirect effects on the environment, their impact and influence on the societies in which they do business and the diversity and inclusion within their boardrooms and C-suites.

Investors weigh these scores, which on the whole are aimed at predicting the sustainability of a business or industry, and direct their funds accordingly.

But in practice, for businesses and their advisers, the decision making involved in navigating ESG issues has become far less cut and dry, especially when it comes to the M&A landscape in a sector as pivotal to the global economy as power and utilities.

At its core, ESG is viewed by some as a proxy for the risk profile of a business, said Morgan Stanley managing director Eddie Manheimer during a virtual panel presented by global law firm Pillsbury Winthrop Shaw Pittman LLP.

"When you think about the long-term prospects of the business, applying an ESG lens is to some extent just applying a risk management lens to an evaluation of an opportunity," he said.

"Risk management and opportunity identification are indeed the two underlying pillars of ESG."

Businesses also can use ESG matters as a means of identifying opportunities, though, rather than solely mitigating risks.

"Since ESG stories have been in favor, that generally means, all other things equal, those targets are going to trade at higher valuations," Manheimer said. "On the other hand, can those acquirers look at targets and say, 'Is there an opportunity for our company to apply our best practices to this target and help them along the path to a more ESG-friendly story.' "

Risk management and opportunity identification are indeed the two underlying pillars of ESG, and utilities have had these concepts in mind for decades, according to Sempra Energy senior vice president and chief sustainability officer Lisa Alexander.

"When we think about our ESG practices, we have a joke internally that goes, 'I hope to work myself out of a job,' because these factors will become part of how we do business," she said on the panel, "Already, our capital allocation processes factor in ESG, so do our M&A decisions and so do our regular budgeting processes."

Three Little Letters, Endless Implications

The term ESG – which stands for environmental, social and governance – encompasses such a robust list of issues for companies that the lines can become blurred between what initiatives look good on the balance sheet today and what really helps create a sustainable business for the future.

This ambiguity can lead to mixed signals among the various stakeholders of power and utility businesses about what is most important, and also may lead to increased risk based upon regulatory oversight.

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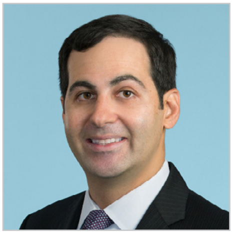

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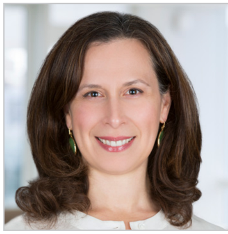

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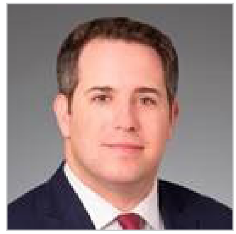

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Last month, the SEC announced the creation of a new Climate and ESG Task Force, led by its acting deputy director of enforcement, Kelly L. Gibson. With the increased attention aimed at ESG-related reporting, firms need to take additional actions to ensure the accuracy of their ESG disclosures, notes Stephen Amdur, chair of Pillsbury Winthrop's private equity practice.

"Investors and companies must be certain that actual processes and practices align with stated goals," Amdur said. "Based upon the SEC's published risk alerts and the creation of the Climate and ESG Task Force, we expect increased scrutiny and examinations will follow."

Private investors also have been taking aim at ESG disclosures and activity. In Elliott Management Corp.'s recent campaign at Kansas and Missouri power supplier Evergy Inc. (EVRG), the activist lambasted the utility for its ESG initiatives. Elliott criticized Evergy's decision to operate coal plants until the "end of their useful lives," and said the company has lagged behind peers that have pledged to reduce carbon emissions significantly.

One of Elliott's solutions, according to Manheimer, was for the company to rate-base more renewable energy, which would increase renewable exposure and drive job growth in a way that supported additional earnings growth while reducing customer rates.

"So a lot of this is cloaked in ESG, but really it's about value and growth," Manheimer explained. "A lot of the folks who have the highest growth rates have an ability to invest in environmentally friendly forms of generation so there is that convergence."

> **"Investors and companies must be certain that actual processes and practices align with stated goals."**

There's also often a convergence in the way investors and companies talk about ESG.

"From an investor standpoint, there are several elements to include in an ESG diligence process," Neuberger Berman managing director and portfolio manager Ronald Silvestri explained. "For a few examples – how ESG factors into management compensation; a company's emphasis on diversity, customer reliability, regulatory relations; and the safety culture."

Amdur highlighted that, especially in industries like power and utilities where focusing on the "E" is so obvious, the importance of the "S" and "G" cannot be ignored, and companies need to ensure compliance with social and governance initiatives – both to ensure accuracy of public disclosures and to protect against longer-term risks.

Safety culture is a particular necessity in the power and utilities space, Alexander echoed.

"Many of our peers have done a great job in this area," she said. "What I've seen is that companies that have a strong safety culture to begin with are already that much more forward in adapting to other ESG-type factors."

And yet, disagreements between companies and investors over ESG initiatives are occurring more and more frequently.

From Alphabet Soup to Standardized Best Practices

Activist shareholders come in many shapes and sizes. There are those who show up around proxy season to make proposals but don't launch formal campaigns, those long-only investors who occasionally make suggestions on management compensation and other matters throughout the year and those more traditional players who launch full-blown campaigns aimed at taking board seats and influencing significant corporate change.

In the past few years in the power and utility space, ESG has become a focal point for all of them, sometimes to the dismay of the industry's other stakeholders.

"I think everybody is sick of the alphabet soup of the raiders and how many different ways you can be judged on your ESG metrics," Abernathy MacGregors's head of M&A and activism Patrick Tucker opined. "There's such a desire from both corporates and investors for just some clarity of what matters and some repetition – 'How can I know that I can take one number and compare it to another number.' "

Enter regulators, who have been tasked with providing a framework on how to appropriately codify and enforce ESG responsibilities. For power and utility companies, the regulatory bodies they must answer to include not only the Securities and Exchange Commission, but also various state utility commissions and the Federal Energy Regulatory Commission.

As part of the increased focus from the SEC, acting chairwoman Allisson Herren recently revealed the agency would seek public comment on whether to require that companies make more extensive disclosures to investors regarding climate-related risks. With the increasing scrutiny, Amdur highlighted the need to consider the regulatory overlay from a public disclosure perspective and the considerations of ESG standardized reporting from the SEC.

"The bottom line is frameworks for responsible disclosures are important," Sempra's Alexander echoed. "And the more we can get to a streamlined and consolidated sense of those metrics that make the most sense for investors and others, that'll help everyone interpret the data better."

Because gone are the days where ESG can be swept off as secondary to a company's core business strategy.

"Just as we're seeing ESG rise with investors and others, I think it is top of mind with some of our regulators as well."

"I think we're finding the risks are rising on that," Abernathy's Tucker said. "Exxon is a perfect example of a company that was perhaps not as quick or as public with its environmental disclosures, and there are a new class of investors that are looking to increase attention on that and put pressure on the board in that aspect.

"And I think you're finding investors are recognizing that's a prudent move, and there is meaningful support behind it," he added. "It is not a risk-free endeavor to let this sit as a secondary matter in the boardroom."

But not all regulators are on the same page or timeline. For example, while California has for decades asked tough questions regarding issues that fall under the ESG topic, such as safety and diversity, other regulatory bodies are just beginning to ask those questions, Alexander said.

"As we talk about other regulators, whether it be other states or at the federal level, I would say we're starting to see a rise in questions related to those ESG factors," she said. "Just as we're seeing ESG rise with investors and others, I think it is top of mind with some of our regulators as well."

In the utilities space, companies' ESG progress tends to move in lockstep with region-specific regulatory guidance.

"The way that one utility responds is very much driven by the service territory in which it operates," Manheimer explained.

That's why businesses in California may be viewed as ahead of the curve on some environmental and social issues, while businesses in more coal-friendly territories have fallen behind the curve.

"But the markets are clearly favoring ESG stories so in order to help bolster their cost of funds, they have to acknowledge the ESG signal in the market by adapting their business models to the current conditions," Manheimer posited.

"Ultimately the ESG objectives have to correspond with the conditions on the ground, and so for companies that are dealing with those conditions on the ground that may be less ESG-friendly on their face, a lot of it is 'How do we tell a greening story; how do we talk about what the future looks like; and how do we consider how that's going to impact our customers who rely on the jobs that are generated by our utility operations?' " he said. "It's challenging, and it's an ever-evolving situation."

Acquiring a Green Thumb

So how does M&A factor into all this for power and utility companies?

For one, these businesses are spending a lot more time identifying and analyzing the red flags that pop up in the diligence process for potential targets. As Amdur noted, managing the risks associated with employee responsibility and internal workplace culture, while sometimes less obvious, can be just as important as the environmental concerns. And it helps to start at the source.

"Safety is really an issue that is very challenging, quite frankly, to predict," Neuberger Berman's Silvestri said. "That's why the right leadership being in place is just so critical when making investments in any of these companies."

Strong management qualities and corporate culture are key to navigating the associated risks of running energy infrastructure and supplying customers with a vital product.

"It all goes back to culture," Sempra's Alexander said. "So a company that hasn't done a great job managing risks up to the point of a transaction, I imagine will have a pretty tough foot to put forward in the context of a transaction.

"Because at the end of the day, it's values and vision, practices and people, and then how the company is a good actor externally," she added. "So I think that in the context of M&A if those lenses are applied through the transaction process, that will probably help give a pretty strong sense as to whether a company is managing its risks effectively."

After all, utility businesses have for decades been viewed as haven stocks with low-risk profiles and guaranteed shareholder returns in the form of dividends. But investors have witnessed several black swan events over the past few years to shake their conviction on how risk-free this industry is, according to Manheimer.

"In the context of the transaction, it's important to go through public disclosures, get to know the management team and really kick the tires to make sure you understand the risks because it's really difficult once you're in transaction documentation to walk away," he said. "Once you're at that point you kind of own those risks."

To be sure, utilities' M&A processes already have a built-in mechanism that often serves to improve their ESG scores.

> **"You're not just thinking about investors, you're thinking about value to other stakeholders."**

"Utilities have the public interest requirement, which is a blessing and a curse for the sector in M&A," Abernathy MacGregors's Tucker said. "It's a blessing in the sense that it forces you to focus on your ESG factors in your pursuit of deal approval, and it can really start to shine a light as you think of your path from announcement to approval and your ability to close a deal. You're not just thinking about investors, you're thinking about value to other stakeholders.

"It is a curse in that you have to go through that process, which is by no means easy and in some cases quite fickle, but other sectors are just starting to come around to that notion of talking to other stakeholders in a transaction. And that is table stakes already in utility M&A."

With these safeguards in acquirers' minds as they approach deals, some see the next three to five years as a potential boon for power and utility M&A.

"We just see rapid decarbonization and green energy upside as consolidation drivers, and all of that enhances ESG scores," Silvestri said. "We do believe consolidation activity will accelerate."

Silvestri pointed to Wall Street darling and renewables powerhouse NextEra Energy Inc. (NEE) as a continued buyer moving forward, while mid-cap utilities that are rapidly expanding their renewables base, such as Alliant Energy Corp. (LNT), stand out as potential future targets.

"The flavor of the past year has been separation transactions, with a lot of companies looking to rebalance portfolios, particularly toward a more pure-play regulated business model," Manheimer said. "Once those transactions close in the next 12 to 18 months, we're going to have an entirely new strategic landscape in front of us, and I think that should lead to more M&A. I think you're going to find a lot of parties on their front foot looking to acquire other utility names."

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