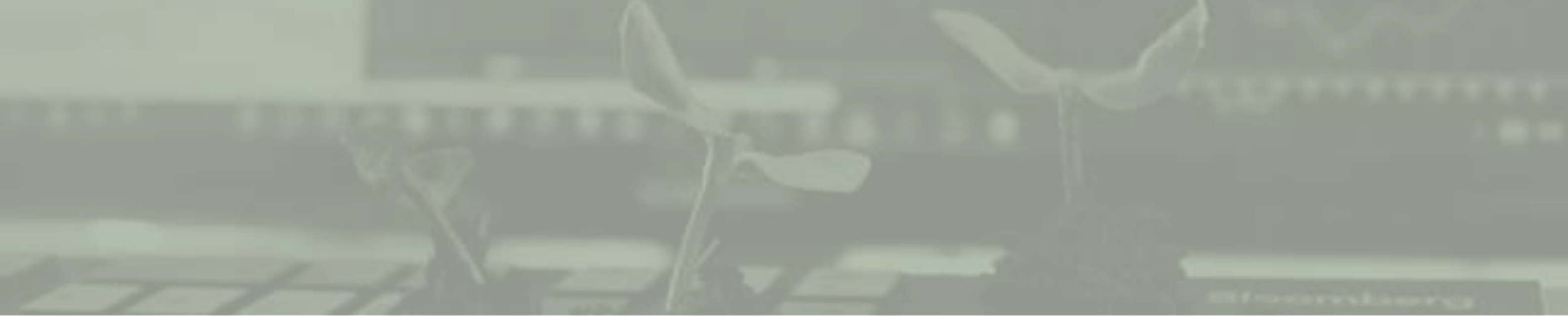

Top coal, top ESG?

Ulf Erlandsson(*)

- Adani Power (ADANI), India's biggest publicly traded private coal utility company, has achieved a 94th percentile CSR/ESG metric score as per one of the ESG scoring aggregators (Figure 1, higher is better) and is included in an important emerging market ESG index. With 99.7% coal based generation capacity, we believe the company should be affected by coal investment exclusion criteria rather than a candidate for best-in-class ESG inclusion.

- Adani Power is likely to delist from the public equity market in the near future. There is substantial appetite in the market for private debt, which may be highly relevant to finance this buy-out. It is our view that involvement or investment in ADANI refinancing and bridge debt is not aligned with a credible coal exclusion policy.

- Minority equity investors, including international institutions, have seen the Adani Power's stock underperform the Sensex index by approximately 34%/17% year-to-date/since delisting announcement. Coal exclusion criteria with particular fine print, e.g not being applied to passive product construction or by application weak 'production-based' rules, can been expensive for end investors.

- In general, we would caution on using ESG ratings based on unsupervised big data or algorithmic approaches as they could be subject to both stratification issues as well as reverse engineering/spoofing. It should be expected that companies and other issuers of fixed income capital will put effort into artificially inflating ESG ratings.

Figure 1. Screenshot of ESG rating of Adani Power, as per 20 July, 2020.

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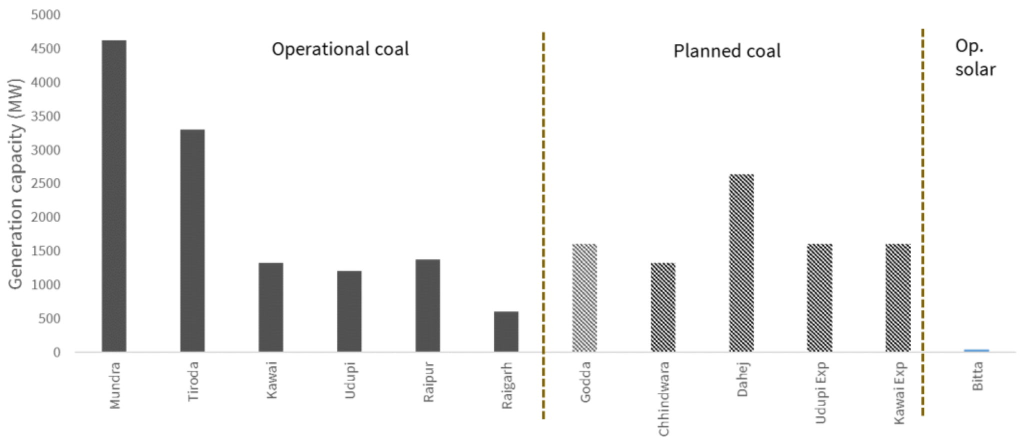
Adani Power generation capacity and exclusion rules

We summarize the generation capacity of Adani Power (corporate ticker ADANI) in Figure 2. Current renewables generation is 0.32% of currently operational capacity, and 0.18% including planned coal expansion. As a comparison, the Danish utility Orsted (ORSTED) which only ranks in the 85th percentile in the aggregator has 85% renewables capacity.

Figure 2. Adani Power generation capacity. Currently operational capacity numbers from company annual report presentation 2019, and planned capacity numbers from website, 20th of July, 2020.



It should also be noted that **Adani Power is not affected by exclusion criteria** from some large, global investors, as the company does not actually produce the coal it burns. Many coal exclusion lists have the requirement that revenues from coal production, as opposed to coal consumption, must not exceed 25% of company revenues. This is one of the fine-print details that ESG minded investors should be aware when they evaluate asset managers.

As a background, Adani Group is a conglomerate with activities across the energy spectrum, where Adani Power is one of several horizontally placed subsidiaries. The Adani Group has globally significant thermal coal mining activities in Adani Enterprises Ltd (ADEIN), a listed sister entity within the conglomerate, making it possible for Adani Power to avoid production based criteria.

For example, for some it would be commensurate with coal exclusions policies to invest in Adani Power in a scenario where the company procures its coal from the Carmichael coal mine currently being built in Australia[1]. The actual production could happen in the Adani Australia subsidiary with logistics being provided by the Adani Abott Point (ADAABB) and Adani Ports and Special Economic Zones (ADSEZ) sister companies. It should also be noted that there is more coal-based generation capacity in the Adani conglomerate through the Adani Electricity Mumbai (ADANEM) entity, a subsidiary of Adani Transmission (ADTIN). This illustrates the potential lack of bite with production based coal criteria in larger corporate structures.

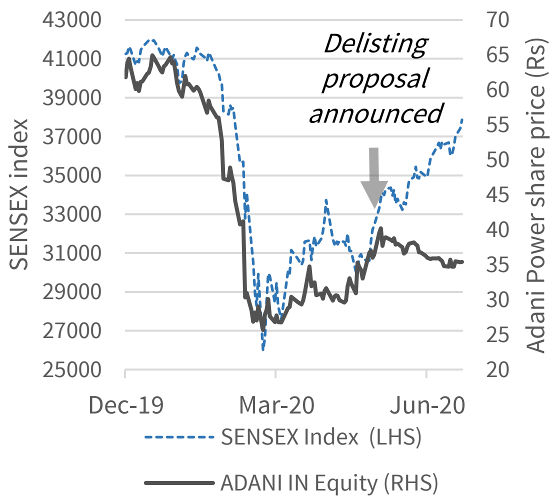
[1] See "The World's Most Insane Energy Project Moves Ahead", Rolling Stone Magazine, June 14, 2019 for an overview. After the go-ahead from the Queensland (QTC) government in 2019, the mine has now commenced production and is planned to start exports in 2021: "Adani starts work on Carmichael mine", World Coal, 16 July 2020.

Adani Power delisting: from public equity market to where?

The ownership structure is yet another reason why we find it unlikely for Adani Power to score high on an aggregated ESG metric. Adani Group has held a clear controlling stake (approximately 75% earlier this year) in Adani Power, giving any remaining holders of the equity a minority position, with the downside risk of being bought out at low valuations. Indeed, as of recent announcements[2], **Adani Power will likely delist its public equity and be taken private within the not too distant future.** A majority of 90% of shareholder votes is required in order to delist the company.

The pattern to move coal activities into more opaque non-public vehicles is not a new one and has been well-tested in Europe[3]. We currently have little information on how the buy-out of Adani Power is being financed. In traditional (leveraged) buy-outs, there is substantial bridge financing supplied by commercial banks and/or alternative investors. **We believe it would be inconsistent for a bank or an asset manager committed to stop financing coal to provide bridge financing in this context.**

The Times of India article referenced above mentions that the buy-out will give the company access to "new financing structures." suggesting alternative long-term financing sources. We currently see substantial investor appetite for private debt in fossil sectors, as exemplified by Total's (TOTAL) recent LNG deal in Mozambique[4]. That deal marks the biggest ever private debt deal for African markets, with support of institutions such as the Export Import Bank of the United States and the Japan Bank for International Cooperation (JBIC), as well as several commercial banks**. We believe climate-aware ultimate bond investors in such entities should be wary of their investments being lent on to coal, in general and in this particular case.**



We see a number of global asset managers and pension investors as holders of Adani Power in their portfolios[5]. It should be noted that most of the managers and investors appear to have had exposure through passive vehicles, such as ETFs or tracking-error constrained benchmarked funds. We note that the company is a constituent of the emerging market ESG index of one of the global equity index providers. The end investors in these vehicles or index trackers have seen the stock decline by ~43% year-to-date. In comparison, the SENSEX index is down only 8.8% year-to-date (31 July, 2020), letting **ADANI investors nurse relative losses of around 34%.** The underperformance since the announcement to delist is around 17.5% versus the index.

[2] See "Adani to offer Rs 3,265 crore to take power co private", The Times of India, 23 June, 2020, or "Gautam Adani plans to delist Adani Power", Bloomberg/FE Online, 1 June, 2020.
[3] See for example "Vattenfall sells German lignite assets to Czech EPH". Reuters, 18 April, 2016.
[4] See "Total secures Africa's biggest debt financing with LNG deal", Financial Times, July 16, 2020.
[5] Holding information snapshot as of 20 July, 2020. The information is based on various sources and may not represent a current picture.

The Anthropocene Fixed Income Institute is a non-profit organization "to monitor, advocate for and influence the impact of the fixed income and bond markets in the age of human induced climate change." For more information about the Institute, please visit wwww.anthropocenefii.org or follow us using the hashtag #anthropocenefii.