# Valuing assets in a low-carbon economy

## Why business leaders would do well to think about how a greener future may affect the value of their business

*Paul Sheridan is an Environment Partner at CMS in the UK*

When asked how the move towards a low-carbon economy will affect the value of assets and corporations, Paul Sheridan can probably offer more scenarios than most business leaders have ever considered. "With the demise of the car, what value should be attached to a petrol station forecourts business in even 10 years' time?" he asks. "How will a company that is dependent on its employees commuting long distances by private road vehicles survive increased road transport pricing? Alternatively, with improvements in alternative energy, will employers be able to set up businesses in areas that previously were no-go areas because of a lack of national or centralised energy infrastructure?"

In giving these examples, Sheridan, an Environment Partner at the firm, links the prospective economic value of a business to its ability to face the risks and opportunities arising from the countdown of the carbon clock. At the transactional level (particularly >

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in due diligence), there is currently a widespread lack of appreciation, never mind practical and financial understanding, of the economic implications of the move to a low-carbon economy. If such failure is maintained, canny buyers will exploit unprepared sellers and investors will become more cautious.

Virtually all governments of major economies are imposing an array of direct and indirect legal and policy measures that push energy efficiency, or the use of alternative energy. They are also setting targets for carbon reduction, with end dates such as 2020, 2030, 2050. Some businesses may believe there is no immediate need to assess how the trend towards a low-carbon economy will affect their businesses.

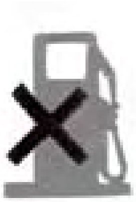
Sheridan believes this approach is dangerously short-sighted, however – particularly for buyers who intend to re-sell the business within a few years. These buyers should be making an assessment on acquisition of how the next buyer, on divestiture, is likely to value the low-carbon risks and opportunities of the business. Sheridan suggests that the ability to demonstrate a vision of and an adaptation to a low-carbon economy could become a feature of the transactional due diligence process. Initially it may be fairly irregular, but over a short period of time it is not difficult to see how it could become a standard feature.

Companies will have to develop strategies to meet the low-carbon world. In the event of a sale, failure to do so could easily affect market value. “In acquisitions, well-advised buyers will begin to carry out much greater due diligence on the target company’s ability to meet the future requirements,” Sheridan suggests. “For instance, a manufacturer producing electronic goods that will not meet the future legal and procurement requirements in respect of standby and energy use may find a negative impact on its sale price or saleability.”

*Failure to have a low-carbon strategy in place could easily affect a company’s market value*

Furthermore, Sheridan believes that there are direct analogies with the credit crunch. He believes that, as happened to the banking crisis, we have been warned that there are problems in the system (in this case, the system is the planet) and that we have been warned that a correction will occur.

As with the credit crunch, the correction in this instance is also likely to be severe for assets and



businesses that have not taken into account the effects of a low-carbon future. Once understood, this should lead to more considered due diligence by banks and other investors. "Right now, there's a convergence of environment, economic and other policies that are currently in the process of being backed up by law and that all tend to ask questions concerning how we should be valuing assets and businesses," says Sheridan.

Aside from the various laws relating to the promotion of energy from renewable sources, there are developing laws at UK and EU level that ought to be considered, both directly and indirectly. They cover areas such as climate change instruments generally (including the world's first Climate Change Act, passed at the end of 2008 in the UK, which contains a target of reducing the UK's carbon dioxide emissions by 80% by 2050), energy efficiency of buildings, measures to reduce energy consumption within buildings, the promotion of micro-generation within real estate developments, public procurement of clean and efficient road transport vehicles and $CO_2$ emissions from new passenger vehicles, to name a few.

On top of this, there are also developing industry sector policies and voluntary agreements.

**The cleantech sector**

From a legal and procedural point of view, some of the new legislation contains two important legislative developments that have generally been overlooked but that Sheridan believes may prove to be pivotal. So, for instance, in the EU's Energy Performance of Buildings Directive and Water Framework Directive and in the UK's Climate Change Act, the Commission and government are legally obliged to carry out periodic reviews (for example, every five years) of the workings of the legislation. Similar legislation is to be found in other countries. Thus, governments and the Commission cannot merely sit back and wait to be lobbied. Instead, they must proactively assess how the legislation is working against set targets or prescribed objectives.

The second aspect is that, in carrying out such periodic reviews, governments and the Commission must acknowledge developments in related clean technology. The simple principle is that as cleantech develops – particularly as new cleantech becomes commercialised – the law is intended to likewise develop. This is a win-win scenario for the cleantech sector. Governments also see this as positive for cleantech as it is becoming one of the fastest growing sectors in the western world, creating jobs, developing technology and benefiting the environment. As Sheridan explains, we should not underestimate the lobbying power of the cleantech sector: "Even now, the cleantech sector globally is probably larger in financial terms than the pharmaceuticals or the aerospace sectors." >

## *Case history*

### The hotels sector

**The hotels market is an example of a sector likely to be affected by the move towards a low-carbon economy. Firstly, the lifespan of a typical hotel means that developments currently at the planning stage will have to be built with either the 2020 or 2050 carbon reduction targets in mind. Secondly, the hotels market will also be directly affected by the wider changes to the economy that will have to be made in order for countries to meet their agreed carbon reduction targets. When the lifecycle of a typical hotel is compared with the estimated date at which known reserves of oil will be exhausted, the dependency of the hotels sector on a sustainable energy market becomes all too apparent.**

**Paul Sheridan asks if tourists will be increasingly dissuaded from taking long-haul flights if such flights attract punitive carbon taxes. "In order to remain economic, resorts will have to be sufficiently close to major population centres, so that they can be accessed by short-haul flights," he suggests.**

**Besides accessibility issues, all new hotel developments will be subject to the full range of 'sustainability' legislation that also affects all other industry sectors. These include waste reduction obligations during the facility's construction, designing low-energy and water use requirements, plus various statutory and non-statutory codes applicable during its subsequent operation – for example, relating to the recycling of consumables, or the use of carbon-guzzling patio heaters. Even machinery and cleaning fluids used at the hotel complex will be subject to new sustainability targets, whether they relate to the safe disposal of discarded cookers or the packaging used when supplying the detergent required to clean the guest's towels.**

The move to a low-carbon economy is so daunting that it is understandable that many will choose to believe it won't happen or choose to address it when it does. They will tend to leave it to others to sort out, especially governments and regulators. But policymakers are already putting instruments in place, and there are hundreds of them. Examined on a one-by-one basis, they do not look too daunting, but looking at them as a whole makes an entirely different picture. The commercially astute will be aware of this and will be aware of the opportunities that are opening up. Those who choose to ignore this do so at their peril.

Sheridan does not delude himself that the tasks ahead for directors and senior managers are easy. He is frank that the current economic crisis provides little scope to think of the bigger picture. He believes, however, that many opportunities will arise from the transformational change to a low-carbon economy.


As the cleantech sector itself is tipped to grow, there are also likely to be many inter-industry ventures that until now haven't been considered. There is already a strong and growing nexus between the waste and energy sectors in relation to various forms of energy that can be derived from waste materials.

The real estate sector and the cleantech sector will surely begin to understand the benefits of collaboration in relation to many aspects of, for example, energy, waste and water management. Sheridan believes that, in the near future, strategists within the real estate sector will begin to understand, for instance, that the financial modelling of on-site microgeneration and technology for energy management and efficiency is not simply a question of capital costs and payback periods, and how this fits into the developer/landlord/tenant relationships. These provide a form of hedging and independence from volatile energy markets that is also a financial consideration.

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Likewise, the massive developments of offshore wind and marine renewables is likely to drive opportunities for onshore support industries and real estate around relevant ports. All in all, we are likely to see significant change, and sooner than is generally appreciated. ○

**For more information,** please contact paul.sheridan@cms-cmck.com

## *Green agenda*

### Be prepared…

- **2020 compliance will soon become a standard part of the M&A due diligence process. If you are considering selling your business, be prepared to comply with or explain your carbon reduction strategies – or pay the financial price.**
- **The new Companies Act places specific obligations on directors to act in the best interests of their companies. In light of the new carbon reduction duties, have you considered whether your company's existing working practices breach those statutory obligations?**
- **New climate change laws give the UK government sweeping powers to meet its carbon reduction targets. Does your company comply with emerging carbon reduction best practice – and, if not, why not?**
- **To reduce their carbon emissions, companies will have to join forces with those in other industry sectors in order to develop innovative solutions. Have you considered other sectors with which you may need to work?**