## The return trap in renewable energy investments

In the latest edition of our *Insights* (Megatrends in our portfolios – Zooming in on a key component of structural growth) series, we identified the Green Revolution as one of the three most important structural megatrends driving the global equity universe over the next decade and beyond. The most significant part of this revolution is the shift away from fossil fuels and towards net zero emissions. Of course, renewable energy has an important role to play here. The battle against Climate Change should thus provide a lasting growth tailwind to the sector. And yet, we are hardly invested in the space. In this *Spotlight*, we want to explain to you, why we see so few attractive investment opportunities in renewables.

**2020 was a winning year for renewable energies.** Driven by political support from all corners of the world (e.g. the EU's Green Deal, the Chinese new five-year plan and the election promises of the U.S. Democrats) and ever-increasing demand among investors, shares from directly profiting and related industries experienced an impressive bull market. There are numerous stocks from the wind power, solar or hydro-fuel industries that have gained hundreds in percent over the past year. But perhaps it's enough to simply mention that the iShares Global Clean Energy ETF - a basket of stocks in this segment - gained nearly 140% in 2020. For the MSCI World, it was comparatively only 13% (incidentally still a remarkable result for us, especially for a Corona year).

**Fig. 1: Performance in 12-month periods**

| | 05/20 – 05/21 | 05/19 – 05/20 | 05/18 – 05/19 | 05/17 – 05/18 | 05/16 – 05/17 | 2020 |
|---|---|---|---|---|---|---|
| **iShares Global Clean Energy ETF** | 93,5% | 21,1% | 5,6% | 14,8% | 3,4% | **141,8%** |
| **MSCI World Index** | 41,5% | 7,4% | 0,3% | 12,2% | 17,1% | **16,5%** |

Source: Bloomberg, in USD

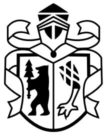
This extremely positive price development was interpreted by many as a signal that the trend towards renewable energies and related shares should also be reflected to a greater extent in a quality growth portfolio. This is a question we are being asked more and more frequently, and in this *Spotlight*, we would like to explain **why we are invested comparatively little in this market segment.**

**Across the Berenberg Equity platform, we focus on companies that benefit from structural growth trends.** One of these trends is certainly also the shift towards renewable energy. We are convinced that the ever-increasing pressure to combat climate change will also be reflected in durable growth rates. This trend is supported not only by governments, but also by companies, which are spending more than ever to be well positioned in these newly emerging markets. This is leading to technological innovation, broader product ranges and lower costs. In addition, there is an ever-growing consumer demand for sustainable supply. Through a positive interaction, these various drivers accelerate each other, ensuring sustained growth rates.

The following publication is part of the Berenberg Funds and Solutions series:

- Insights
- ► Spotlight
  - Equities
  - Fixed Income
  - Multi Asset
  - Systematic Solutions
  - Overlay
  - ESG

***Spotlight*** *offers insights into the Berenberg product universe and highlights key topics in connection with current market developments.*

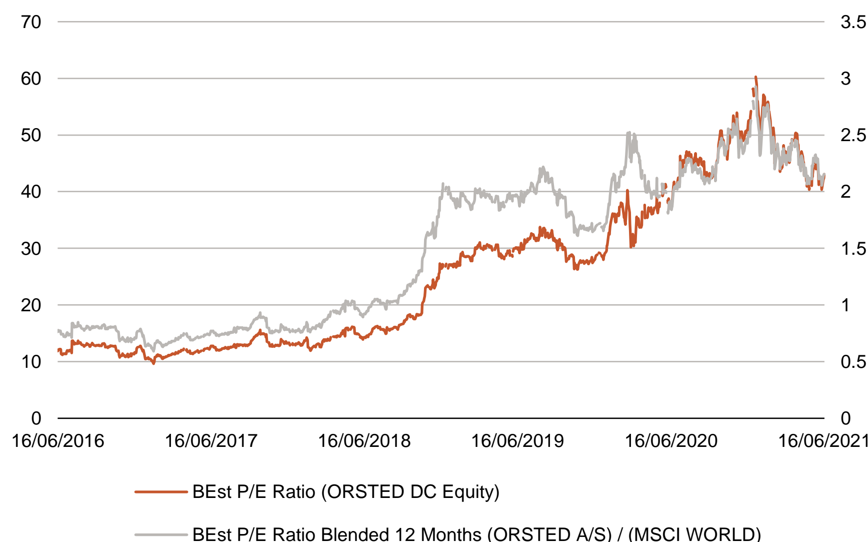


**However, the structural trend is not the only decisive factor for us.** Firstly, growth must also be profitable and result in attractive returns on capital. Secondly, everything has its price. As investors in high-quality growth companies, we are used to higher valuations. But the valuation must always be in proportion to the profitability and sustainability of the growth.

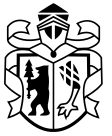
**We only invest in companies that deliver exceptional returns on capital over long periods of time.** This is only possible for companies that benefit from strong competitive advantages. Not every company that is exposed to a structural growth trend can fulfil this criterion. There are even entire industries that are growing strongly, but in which no company can stand out from the crowd, but rather the cake must be divided among many.

**A good example of this is the business of operating renewable electricity generation units.** Renewable energy is a market that has shown enormous growth rates in recent years. However, this growth is increasingly accompanied by falling returns. In 2017, the world's largest operator of offshore wind farms, the Danish company **Orsted**, was still planning on annual returns of close to 10% for new wind projects in the period up to 2025. Over the last few years, Orsted has had to further reduce its target returns to slightly above mid single-digit percentages by 2027(source: Orsted). Its German competitor, **RWE**, also estimates that only 5.5-8.5% returns are possible in developed wind markets going forward. A similar picture can be sketched in the market for solar projects in Europe. What is the reason for this? **The attractive business has attracted a lot of competition.** In addition to the traditional operators, there are, for example, many institutional investors such as insurers and pension funds, which are increasingly looking for alternative investment opportunities in a persistently low interest rate environment. In addition, there have recently been a number of large oil companies that hope the projects will help them achieve their long-term climate targets. In the absence of significant competitive advantages, Orsted, despite its size, has no choice but to bid and settle for lower returns. This is just one example, but it reflects the competitive environment well and explains why we are treading carefully here.

**Fig. 2: Development of the Orsted price-earnings ratio**

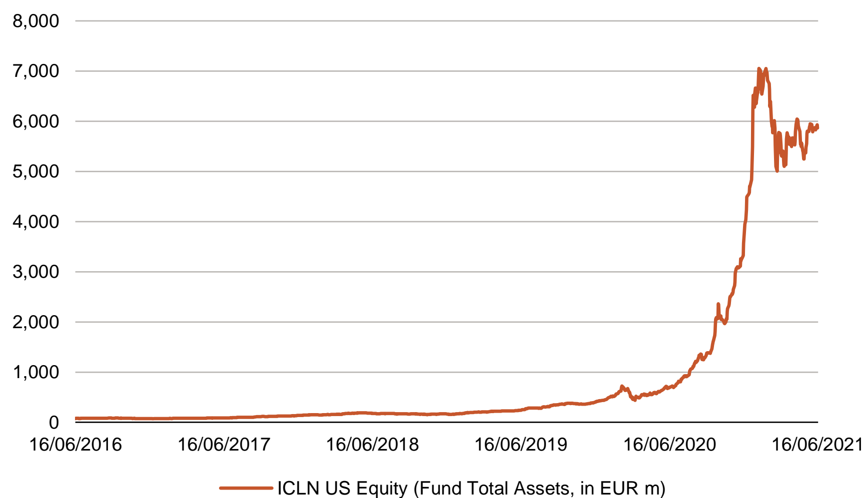



Source: Bloomberg, 16.06.2021.



Another reason for our reluctance can be traced back to valuations in the market. Let's stay with the example of Orsted. As already mentioned, the company has had to significantly lower its expectations for project returns in recent years. Over the same period, however, the stock's valuation has moved in the opposite direction. **Indeed, since 2018, the twelve-month forward looking P/E ratio has risen from 15x to 40x most recently (it was as high as 60x at the beginning of the year).** Over the same period, the valuation of the MSCI World rose from 14x to just under 18x. Thus, there is now a relative valuation difference of more than 120%, which ultimately also explains a large part of the price development (source: Bloomberg). The same analysis with the same result can be repeated for any number of other stocks from this segment.

**Fig. 3: Total assets of the iShares Global Clean Energy ETF**

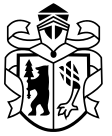



Source: Bloomberg, 16.06.2021.

This raises the following question: What actually leads to this significant premium expansion of renewable energy companies? **In our opinion, it is primarily investor capital flows that are driving valuations higher.** For example, ESG funds' assets under management again saw rapid inflows last year, leaving them past the remarkable $1.5 trillion mark, according to Morningstar. Just five years ago, the figure was just $500 billion. Add to that ESG ETFs, which, according to Bloomberg, saw their assets under management increase by another $89 billion in 2020 alone. Of course, ETFs that focus explicitly on renewable energy, such as the aforementioned iShares Global Clean Energy ETF, are also benefiting from this trend. **This strong demand for rules-based mutual funds means that the underlying stocks are subject to continuous buying pressure.** Should this change, as we have seen in the first quarter of 2021, prices may be exposed to a rubber band effect in the opposite direction. To be invested at that point in time, should be eagerly avoided.

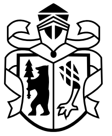
**While we are currently struggling with investments around the trend towards renewable energies, there are other market segments exposed to the Green Revolution that we do find highly attractive.**

The electrification of cars is one such trends and, driven by regulatory support, technological progress, and growing consumer acceptance, it is rapidly gaining momentum. While it is still difficult to tell which carmaker will ultimately win the race, there



are certainly some beneficiaries in the value chain that are worth considering. One example is the German semiconductor manufacturer **Infineon**. Semiconductors are essential for electric vehicles. Compared to an internal combustion engine, an electric vehicle requires four to five times more semiconductors. Despite the energy-intensive processes used to produce semiconductors, Infineon manages to save around 56 million tons of $CO_2$ equivalent (ratio of approx. 1:35, source: Infineon) with the 1.61 million tons of $CO_2$ equivalent it emits itself with its products and the final application. With more than 40 years of experience in automotive semiconductors and a particularly strong market position in critical power semiconductors (2x higher market share than the global number 2), Infineon is well positioned to benefit from the strong growth. As a result, Infineon has been able to generate returns on capital employed well into double digits over the past years.

**Our conclusion:** The trend towards more sustainability and renewable energies remains exciting and should generate attractive growth rates in the long term. However, this growth must also be reflected in attractive returns on capital and positive cash flows. This requires an attractive competitive environment and high barriers to entry. In addition, the opportunities that are identified also need to trade on attractive valuations. Consequently, we don't want to be the last to jump on the metaphorical bandwagon. This also explains why we have so far held back on investments in the renewable energy sector in the Berenberg Sustainable World Equities Fund. The fund concept is specifically designed to invest in companies that offer solutions to global challenges, such as climate change, of course. However, our quality and valuation criteria must also be met. For this reason, this topic currently accounts for only a small weighting in the portfolio. If something was to change about their positioning or valuation, we would be ready to act and take advantage of these opportunities.



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