

Why has green been so blue?

19 July 2021

With the election of Joe Biden and a climate change-friendly administration gearing up for massive policy support, as well as the surprise flip of the Senate to a thin Democratic majority, surely the table was set for green-related equities and industries to kick off 2021 with a bang? Instead, it's been worse than a whimper – the iShares Global Clean Energy ETF (ICLN) index has underperformed MSCI ACWI by more than 25 percentage points year to date. As of the market close on June 30th 2021, the ICLN has declined by 16.5% (total return) YTD, ranking near the bottom of all sectors, while the ACWI has risen by 12.3%. Perhaps more surprising to some, the traditional energy benchmarks are among the best performers YTD, with the S&P Global Energy Index ETF 33% higher (total return) YTD. What could be causing such a marked dispersion and overall trajectory in the face of seemingly positive tailwinds and an abundance of positive catalysts for 'clean and green' on the horizon?

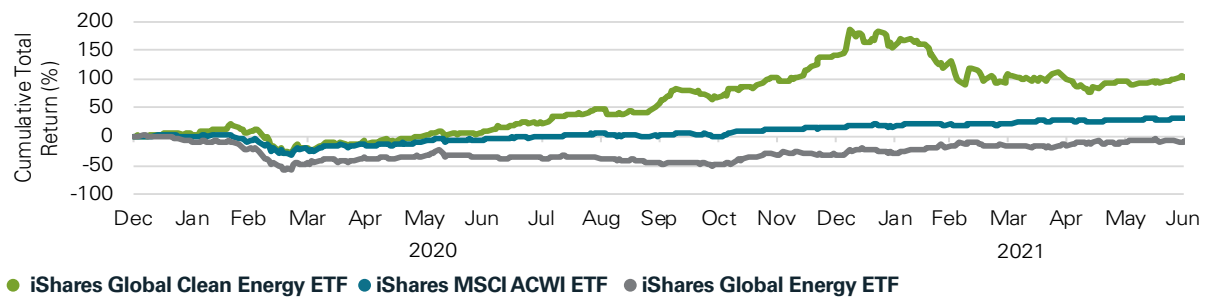
Here are what we think are the three primary factors, and how they are likely to be a mixture of transitory and structural issues.

Point 1

The first point relates to a classic nemesis for all investors: mean-reversion. Markets tend to be forward-looking in nature and discount events and activities long before they arrive. Often there is significant inefficiency in pricing in the short-run related to changes in expectations.

The forces at play driving many of the 'clean and green' industries, particularly around renewable energy supply chains, have been supported and indeed improving for quite some time. We saw in 2020 a crescendo of factors: investors becoming far more aware of the long-term positive growth profile and potential for the sector, which was accompanied by a related but still distinct factor of big new ESG inflows, leading to significant outperformance of 'clean' during the latter part of 2020. While the ACWI and ICLN performances were essentially comparable through the worst part of the COVID market shock, by the end of June 2020, the ICLN's path began to really diverge, and its outperformance accelerated dramatically by Q4. The index finished the year almost 142% higher (total return) – the best return in its existence, compared to a rise of almost 17% for the ACWI and a brutal -31% for S&P Global Energy Index. In that context, the 2021 YTD performance almost doesn't register: since 1/1/2020, the ICLN is still up 102% vs +37% for ACWI.

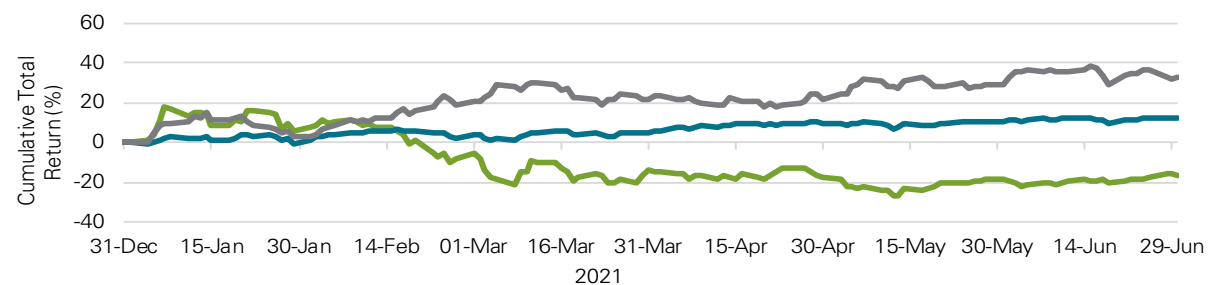
18-month relative performance of ICLN vs ACWI or IXC remains significant



● iShares Global Clean Energy ETF ● iShares MSCI ACWI ETF ● iShares Global Energy ETF

Source: Bloomberg

2021 1H performance shows a quite different picture to 2020



● iShares Global Clean Energy ETF ● iShares MSCI ACWI ETF ● iShares Global Energy ETF

Source: Bloomberg

The problem with 2020 inflows and ICLN performance was worsened by that index having a relatively low level of diversification and some meaningful liquidity constraints, which no doubt played a role in the performance blow-out. Indeed, S&P reconstructed the ICLN index during Q1 to address those problems, almost trebling the number of constituent names and diversifying into many larger cap and lower volatility profile companies. We think this will meaningfully change the profile of its performance proforma, which may or may not be what all investors actually want but which facilitates ETF asset-gathering.

Another unrelated and more fundamental factor also influenced the index's dramatic outperformance last year: the 'clean and green' industry was largely unaffected by COVID. As we examined our clean infrastructure universe, we saw less than 4% of overall earnings estimates revised for 2020 – and most revisions were concentrated in a few names with some economic exposure in their business model, such as with waste-to-energy. Solar and wind operations, manufacturing and new installations continued largely unaffected by the profound global COVID disruptions, in part because much of the manufacturing processes and subsequent project installations are, by nature, socially distanced activities. The existing wind and solar assets of course kept dispatching – taking market share as total electricity demand shrunk slightly related to COVID lockdowns. As the 'COVID re-opening' trade really started to get going in late 2020, we hit 'peak relative 'clean and green' performance' in late 2020...and then of course, the 'COVID economy' stocks started a big recovery in late Q4 which has continued largely into 2021 (until recently).

We think a lot of this relative timing impulse and resulting performance impact has largely played out now. Growth rates within 'clean and green' are broadly intact and remain higher than the market overall which, combined with consistent levels of overall margin and profit potential, would imply these two indexes are not meant to necessarily mean revert over the long haul anyway.

Point 2

The second key factor of influence has been inflation: and this picture is a bit more nuanced.

Renewables assets and projects are formed either as commercially competitive activities, often with long-term bilateral contracts over 15-20 years, or as regulated undertakings within a traditional utility rate-base. In the first case, a project developer bears the risks on costs required to complete a particular project, against a price that is generally agreed upfront. Most large-scale platform developers hedge virtually all their raw materials price risk concurrent with the signing of the power purchase agreement (PPA) contract, so while a few smaller scale players may get caught out a bit on cost-price squeeze, we don't think this is a widespread risk. Rather, the risk is that within a rising cost cycle for raw materials and logistics, it is likely that developers will need to pass along these costs to the next contracts they sign. This is a highly competitive industry, where winning these PPAs and growing backlog is vital.

Our channel-checks thus far have shown significant recognition of these issues by quality developers, as well as some encouraging early signs that market prices for PPAs are moving slowly higher to accommodate elevated capex spend and immunise overall expected project returns to maintain expected life-cycle equity IRRs. In most cases, because these projects are over a 15-20 year life, the actual differential of capex cost and overall impact is relatively well contained; for example, a 50% rise in the price of copper might only require a 3-5% increase in the price of the next PPA to keep IRRs constant. Equally, the downward trajectory on overall cost/unit of output continues (outside of raw materials and logistics) thanks to improving productivity/efficiency of equipment, development learning and scale. Lastly, in the past 6 months, the market price for electricity has moved higher, given a confluence of factors including rising prices for coal and natural gas, as well as in the EU a significant increase in the cost of carbon ETS credits (Emissions Trading System). This raises the headroom available for theoretical pricing power for renewables developers as breakevens widen.

The punchline to all this is that we remain confident that new capital formation activities in the industry will maintain historic levels of returns going forward. Renewables remain the lowest cost option for new electricity development almost everywhere on earth, and the speed and scale of substitution continues to accelerate. Decarbonisation of the grid with these resources will be a multi-decade undertaking. We will be looking, though, for some developers to potentially stub their toes in the Q2 earnings season, due to transitory logistics delays, short-term cost-ups that weren't 100% hedged and other factors we would consider 'noise', perhaps offering buying opportunities.

Point 3

The last point just relates to the relative performance between ‘clean’ and ‘traditional’ energy lately. We expect both areas to experience repeated short-cycle impacts, inside of a long trajectory of substitution and overall decarbonisation, where all the growth in energy overall occurs in decarbonised alternatives at the expense of traditional incumbents. This will manifest itself in numerous ways: electricity taking share from liquid fuels; renewables taking share within electricity; and zero net carbon alternative fuels taking share from traditional fossil fuels. The process will be slow in some regards (actual volumes of energy demand for each, year-over-year), and blindingly fast in others (commodity prices may reflect new realities very quickly inside of these plate tectonic moves). As decarbonisation trends clearly take hold, surprises will continue to emerge, one of which is that constraints on spending in traditional energy may outpace the speed of substitution on the demand side, leading to higher near-term returns on existing assets and opportunities to deploy elevated cash flows into new growth areas like blue hydrogen or carbon capture technologies.

The energy transition will not be a straight line – and this presents investors with great opportunities at multiple times over a long investment horizon.

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