Thoughts from the sustainable investing team

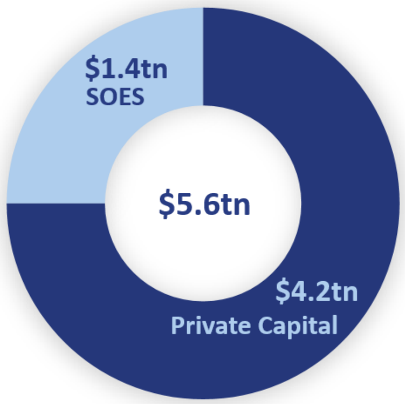
March 2021

Are valuations in green stocks sustainable?

Sustainable investing is going mainstream. We should not be surprised. Our woefully underfunded global healthcare infrastructure is limping its way through a pandemic, and we have been warned by UN special envoy for climate and finance, Mark Carney, that unless we act now to limit global warming, we should expect mortality rates equivalent to the Covid crisis, every year, by mid-century.

Corporates and governments have suddenly been kicked into gear, and we have all woken up to the fact that we are moving through a paradigm shift towards a world that doesn't prioritise profit above all else. The money is moving too. Governments are spending literally trillions of US dollars on the transition to a lower-carbon model, but so are private investors. McKinsey has estimated that by 2040, $4.2 trillion will have been spent on renewable power generation alone.

Projected renewable power generation investment (by 2040)



SOEs – state-owned enterprises
Source: McKinsey

Whether you are a believer or non-believer in climate change, the political capital to restore our environment is being mobilised everywhere. With significant momentum building, tackling climate change through investments in renewables, sustainable infrastructure, electric vehicles or hydrogen is a major focus for investors today. So come the concerns that investing in this space has already become as frothy as a punt on the future value of cryptocurrency, or as directional as following Reddit lemmings over a proverbial cliff.

Whilst it certainly can't be denied that some individual green stocks (those that can often be found in 'ESG' index tracker funds) are in 'bubble' territory. Plug Power, Ballard and Fuel Cell Energy are currently enduring significant losses and are expected to continue as unprofitable companies through 2022, 2023 and 2024, respectively (Bloomberg data). Despite this, these businesses have sky-high valuations reflecting lofty expectations from investors. All three of these names are currently trading between 75 times and 100 times 2021 revenue.

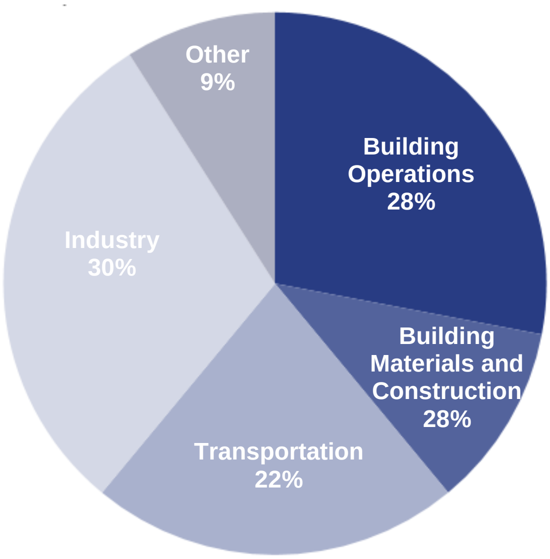
However, these are just a few names in what is a huge universe of companies, across the vast ecosystem of what will be needed for a successful green transition. It is very possible to invest in a prudent and strategic manner, and to future proof a portfolio against the systemic change we see happening in the world around us. We are seeing a multitude of exciting investment opportunities in companies not necessarily at the epicenter, but instead in the supply chain or contributing to creation, production and distribution.

In the case of hydrogen, these businesses are not reliant on the near term roll out, but instead have diversified into the fuel technology through expertise in logistics, industrial fuels or physical technology. It is a similar story across other sustainable investment themes such as energy storage, or even renewable energy.

Green energy production and functionality

There are numerous examples that demonstrate the magnitude of change that will result in sustainable investing going mainstream. Construction and existing buildings are responsible for 39% of all carbon emissions with the operational emissions accounting for 28%. This demonstrates the large potential for 'green building materials' that reduce the energy required for heating, cooling and lighting buildings. Many governments around the world provide incentives for households to upgrade the energy efficiency of their houses and we expect this to be a driver of the industry for decades.

Construction and existing building contribution to total carbon emissions worldwide



Source: Global Alliance for Building and Construction, 2018 Global Status Report.

So, if there are so many investment opportunities within the green transition and only isolated cases of companies with very lofty valuations, why is there so much concern over the whole sustainable space being in bubble territory? We believe it has a lot to do with the speed at which terms such as 'ESG', 'sustainable' and 'impact' have slipped into our lexicon. From descriptions of investment processes to corporate strategies alike, over a short space of time we have all become very aware of how irresponsibly we produce, consume and exist as a society. Everything happens quickly these days, whether it's a shift to home working, or market crashes and subsequent recoveries. Information constantly flies around the world, increasing volatility but also increasing awareness about the problems the world faces.

For some companies, swollen valuations are justified. With the size and scale of the shift away from fossil fuels, or the enormity of the public sector net-zero ambitions or the sheer quantum of money being spent in this space, the future earnings potential for companies that are correctly positioned is huge. In the sustainable portfolios we manage for clients, we utilise the skills of expert fund managers, dedicated to investing in sustainable companies, who have watched the renewable energy, or hydrogen cycle come and go. These are individuals that you want making decisions on specialist technology and nuanced sustainable themes (we spoke to a manager this month about the use of blockchain to trace lower-carbon commodities, for which there is a valuation premium…), not passive ETF giants bundling together all the companies involved in a specific investment theme with a view to simply selling a product.

ESG isn't a bubble, it's a systemic shift in thinking and acting. Avoiding the hype stocks however, is essential. It is very possible to ride the green wave, to invest in companies that are cognisant of the importance of a shift towards a more sustainable future at sensible valuations. If we have learned anything since the financial crisis in '08, it is not to fight the government and the political willingness to shape markets. The governmental will and capital behind reducing carbon emissions as the climate crisis rages will provide extraordinary opportunities for investors for many years to come. We plan to be at the forefront of this green revolution.

Eden Park Investment Management Limited, The Pavilions, Eden Park, Ham Green, Bristol, BS20 0DD, 01275 404 880, enquiries@edenparkim.co.uk, www.edenparkim.co.uk