# Ecofin Energy Transition Strategy

## Q2 2022 QUARTERLY COMMENTARY

### Performance summary

The strategy returned -19.2% (net of fees) in the second quarter while the MSCI ACWI returned -15.7% during the same period.

As of 30 June 2022

| *(All total returns in USD)* | 1 month % | 3 months % | 1 year | 3 years % per annum | 5 years % per annum | ITD* % per annum |
|---|---|---|---|---|---|---|
| Strategy composite (net)** | -10.5 | -19.2 | -28.7 | 7.2 | 7.2 | 9.5 |
| MSCI ACWI Index | -8.4 | -15.7 | -15.7 | 6.2 | 7.0 | 8.2 |

*01/01/2013. **Strategy composite information provided in the disclaimer on final page.

Source: Ecofin Advisors Limited.
**Past performance is no guarantee of future returns.** Returns may increase or decrease due to currency fluctuations.

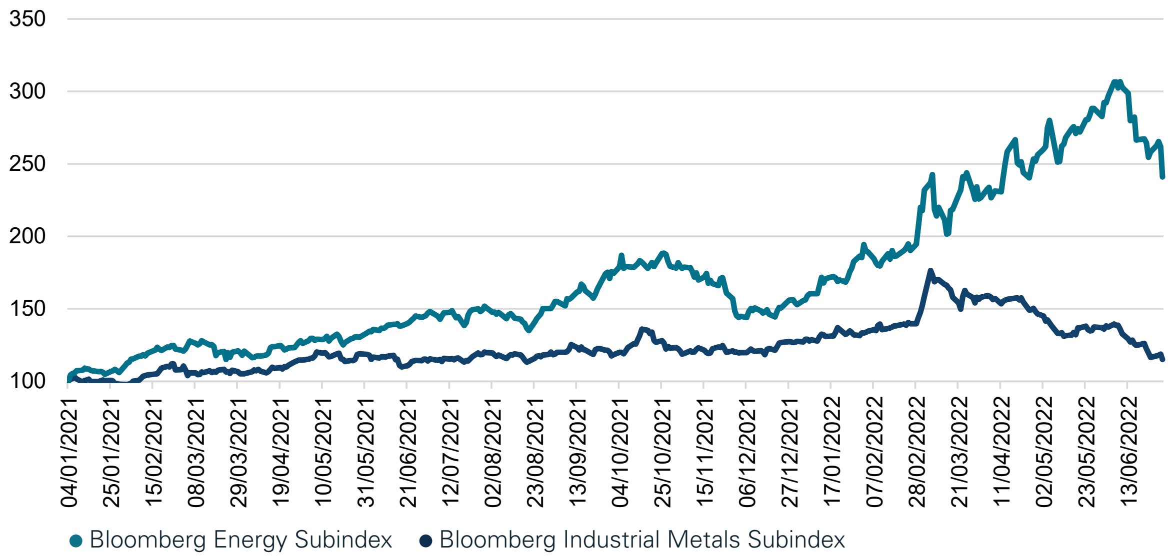
At the end of June, the strategy had 27 positions and by region was invested 31% in North America, 42% in Europe and 25% in Asia. Almost half the position weights have primary exposure to the electrification master theme while the remainder is divided equally between clean transportation and industrial & building efficiency.

The varied macro impulses outlined in the Q1 commentary persisted into Q2 and were a major contributor to the strategy's negative returns during the period. The ongoing underperformance of growth relative to value in the quarter additionally contributed to the strategy's underperformance relative to the market, though it should be noted that with little exception we have not seen any material reductions or slowdowns relating to our core secular growth exposure in energy transition themes. This is quite different from the more generic 'growth' category slowdowns seen in high profile technology names, which were largely exposed to the COVID demand cycle.

Over the course of the quarter, consumer confidence deteriorated further in both the U.S. and Europe, a result of increasing costs of living exacerbated by energy shocks and the rapid move higher in mortgage rates. The drop in consumer sentiment and decline in savings rates are impacting the demand for consumer goods and pricing power of companies selling those goods (a correction exacerbated by the overshoot in demand for goods versus services during the COVID lockdown). For companies in the investment universe with exposure to consumer goods, especially consumer electronics, as there is a risk of margin erosion and inventory build-up in the months ahead. The greater relevance to this portfolio is that this dynamic potentially extends to the Automotive sector, although there will likely be a delay to pricing power erosion for new cars as automotive production is still running well below demand levels because of the semiconductor shortage. The risk is more to reduced pricing power for automotive OEMs in 2023, as we may well see sales volumes positively impacted ahead given the industry is already producing well below current demand levels; on a relative basis a better backdrop for suppliers versus OEMs. Meanwhile, electric vehicle sales continue to show strong growth and rising overall market penetration and, as a result, companies with higher electric vehicle exposure within the automotive industry should fare better on a relative basis. Our strategy is focused on these volume and EV exposures.

A more positive development in the energy transition investment universe during the quarter was the sequential decline in many metal commodities prices. The declines in metals prices exceeded the declines in energy prices (see Figure 1). In fact, in some regions, Europe in particular, energy prices continued to reach new highs. Freight costs also began to recede from highs. Rising metals and freight costs emerged as a growing headwind to the renewable asset and equipment value chain during the second half of 2021, given these would feed into higher equipment and project deployment costs which would, in turn, erode renewable project returns and equipment manufacturer margins. This development is now unwinding; metals and freight costs are falling which should result in plateauing or declining project costs. Concurrently, energy prices (gas, coal and electricity in particular) in many regions remain elevated. We believe the outcome is threefold: renewable project returns have scope to stabilise or improve, the spread between fossil fuel power generation costs and renewable power generation costs (which are lower) are at all-time highs, and the pricing power of renewable generators is improving. Whilst we believe this is generally a positive trend for the entire renewable power value chain, it is worth noting that some important inputs such as lithium carbonate and polysilicon prices have remained elevated owing, in part, to no evidence of a slowdown in demand.

**Figure 1. Bloomberg Energy Subindex vs Bloomberg Industrial Metals Subindex[1]**

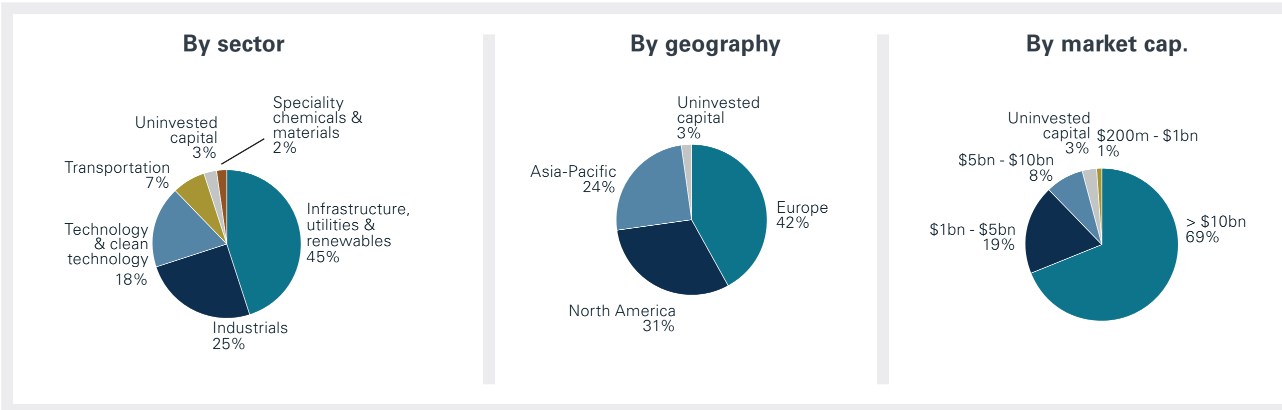



[1]Industrial Metals Subindex: the index is composed of futures contracts on aluminium, copper, nickel and zinc. It reflects the return of underlying commodity futures price movements only. It is quoted in USD.

Energy Subindex: the index is a commodity group subindex of the Bloomberg CI. It is composed of futures contracts on crude oil, heating oil, unleaded gasoline and natural gas. It reflects the return of underlying commodity futures price movements only and is quoted in USD.

It merits mention that, when assessing the strategy's performance YTD, the primary influence has been the valuation multiple de-rating rather than negative earnings or revenue revisions. Equities tend to move ahead of revisions, and we would expect that the almost negligible level of negative earnings revisions seen thus far at the portfolio level may increase, with the magnitude and scope of the global economic slowdown dictating the size of downward revisions to come. Our portfolios consists of companies with a variety of end-market exposures and business modules: some should indeed see positive revisions (such as the renewable asset owners/operators mentioned earlier); some companies are not cyclical (such as pureplay cleantech equipment manufacturers) and are therefore less exposed to the global economic slowdown; and the portfolios indeed also contain cyclical businesses with structural exposure to the energy transition mega trends. Within the more cyclical exposures we continue to focus predominantly on the higher quality cyclicals – those with superior pricing power and the ability to execute well through this period of turbulence. Such "quality" cyclicals have already de-rated meaningfully year-to-date and therefore may have better potential for relative outperformance over the next six months (compared to the last six months).

As of 30 June 2022




## What worked well this quarter

**Constellation** (CEG US), a merchant nuclear power generation business in the U.S., was spun out from **Exelon** (EXC US) in January 2022. The company has the largest merchant nuclear fleet in the U.S. which can benefit from growing demand for zero-carbon electricity as well as the increase in electricity prices driven higher by rising U.S. gas prices.

**Acciona Energias Renovables** (ANE SM), a Spanish renewable energy company with a global asset base, was up slightly in the quarter. The company recently spun out from its parent and has ambitions for substantial growth in its renewables asset base. In addition, the company should stand to benefit from higher power prices in Europe from next year onwards as it has increasing levels of unhedged power price exposure in the years ahead.

## What didn't work well

**Lyft** (LYFT US), a U.S. ride hailing business, was a significant detractor in the quarter. The company beat Q1 results on revenue and EBITDA but Q2 guidance missed consensus estimates. The company claims that Q1 ride volumes were at 70% of ride volumes pre-COVID, sees a recovery accelerating in H2, and wants to get ahead of that by increasing short term investment in driver incentives. The street is concerned this is structural rather than transitory. Meanwhile the backdrop of rising wages, a tight labour market, higher gasoline prices and declining consumer confidence add further uncertainty. On the earnings call management reiterated expectations of FY revenue growth rate above 2021 levels, which implies a significant second half reacceleration. We think the stock is likely range-bound until Lyft can disprove these concerns over the next couple of quarters. Management needs to continue to execute and reiterate a focus on free cash flow generation.

**Schneider Electric** (SU FP), a leading global provider of low & medium voltage electrical equipment, underperformed in the quarter due to its relatively large exposure to China which was under strict lockdown. Investors also worry about the company's expectations for a H2 weighted recovery given the uncertain macro outlook.

**Infineon** (IFX GY), a leading global power semiconductor company, fell in the quarter as a result of ongoing concerns about a global economic growth deceleration and the possible risk of a rapid inventory build in semiconductors. It is worth noting that Infineon has a large exposure to the automotive sector, which should see some volume recovery, as opposed to the consumer electronics end-markets where growth is more uncertain.

## Looking ahead

We believe the second quarter reporting season is likely to deliver a generally reasonable set of results, however investors are likely to disregard historical performance in this fast moving macro environment and focus on guidance and commentary regarding current operating conditions. The major macro themes will remain the most significant drivers of overall equity performance in the near term: the Fed, inflation, Ukraine/Russia impacts on energy (particularly in Europe), China zero-COVID policy and stimulus programs there.

More specifically to the energy transition strategy, progress on U.S. climate policy ahead of or after the mid-term elections could also act as a material positive catalyst. Visibility on a positive outcome is still very low but can evolved rapidly. We also expect a conclusion on the Californian rooftop solar net metering 3.0 regulations during Q3 which would remove a regulatory overhang from companies exposed to rooftop solar.

The threat to Europe of a Russian gas supply shortfall remains acute and is a significant risk to the European economy and the broader global economy. The European energy market is very fragile due to its dependence on imported gas and currently weak hydro conditions. In this context, it becomes probable that Europe will need to contain energy consumption. Moreover, policy intervention to control power prices is increasingly likely in order to limit the rise in the costs of living. Forced moderation in energy consumption could set the stage for a recession and a difficult operating environment for many industries, even if renewables should fare better given their long-term contracts and lower-than average cost positions.

From a regional perspective, China has the potential to show the best sequential growth after a weak Q2 resulting from COVID lockdowns, enhanced by a watering down of COVID restriction measures and a ramp-up of focused stimulus measures. In the last weeks we have already seen purchase tax cuts for the automotive industry.

We are expecting supply chain bottlenecks for critical components, such as semiconductors, to continue to improve which will materially reduce the impact of supply constraints on availability and pricing of products, reduce the false signal of double-ordering within supply chains, and alleviate some of the acute inventory management issues within supply chains. Aside from gas (in some regions) supply bottlenecks, the supply-driven market distortions should dissipate. The main question now is demand.

## Disclaimers

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**Past performance is no guarantee of future results. Returns may increase or decrease due to currency fluctuations.**

**Index Information:**

The MSCI ACWI Index captures large and mid cap representation across 23 Developed Markets and 26 Emerging Markets countries. The index covers approximately 85% of the global investable equity opportunity set. The S&P Global Clean Energy Index is designed to measure the performance of companies in global clean energy-related businesses from both developed and emerging markets, with a target constituent count of 100.