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JUNE 2024

A NEW PARADIGM FOR ENVIRONMENT-LED INVESTMENTS?

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Environment-led investments have been shunned by the market for over two years now. However, their popularity could rise again soon, supported by **central bank decisions** on either side of the Atlantic. The ECB, probably followed very closely by the Fed, has recently initiated a rate lowering cycle that will benefit green stocks, as the latter require the deployment of large amounts of capital.

This change of policy is taking place in a market environment marked by persistently weak investor sentiment on the environmental pillar. Yet, according to our analysis, environment-led investments are trading at **reasonable valuations** and offer an **attractive outlook**.

The transformation of the world's energy systems will be a powerful driver of value creation. These systems are faced with a sizeable challenge and opportunity, namely **the soaring demand for electricity fired by the growth of artificial intelligence**.

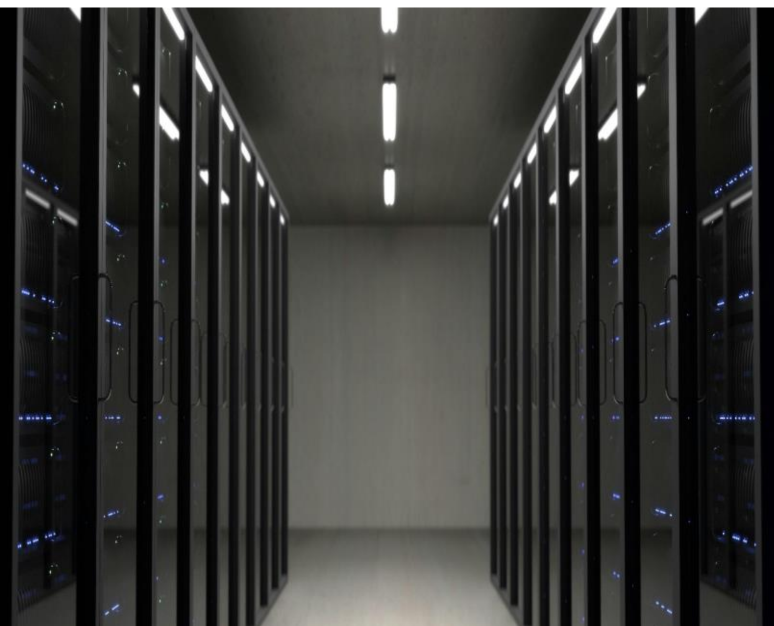
AI, A POWER-HUNGRY INDUSTRY

The fast deployment of artificial intelligence systems is causing a surge in demand for electricity, notably from data centres. Electricity consumption from data centres could double by 2026, rising from 1-1.5% of global consumption to 2-3%. According to IEA (International Energy Agency) estimates, this demand is roughly equivalent to the electricity consumption of Japan.

Companies offering solutions that will improve the energy efficiency of these power-hungry infrastructures, and notably those of the two largest consumers – servers and cooling systems, which weigh 45% and 35% respectively of data centre energy consumption – **should perform well**.

As a result, Schneider Electric, ABB, Eaton, Legrand, Spie and Vertiv are likely to emerge as the main winners from the huge growth in demand for electricity over the next few years. For example, US-based company Vertiv designs liquid cooling systems for data centres enabling a 10% reduction in the total power consumption of these energy-greedy buildings.

The rising number of electric vehicles and the growing penetration of heat pumps should also add 15 to 20% to the global demand for electricity, after a decade of falling consumption in Europe and stabilisation in the United States. These trends will generate many opportunities for market players able to rise to the challenge.



'The ageing infrastructure – which is several decades old – is no longer suitable for handling multiple sources of renewable energy and carrying the extra load'

ADAPTING THE POWER GRID IS A PRIORITY

The threat of power shortages is a reality and calls for **massive investments**. According to the IEA, after stagnating for over a decade, investments should almost double by 2030 to over 600 billion dollars per year to upgrade the existing infrastructure, and more precisely, the power transmission and distribution grids. This ageing infrastructure – which is several decades old – is no longer suitable for handling multiple sources of renewable energy and carrying the extra load.

For regulators, modernising the power grid is the overwhelming priority. Companies such as Prysmian, Mastec, Quanta, Eaton, Nexans, ABB, Schneider Electric, E.ON, and Elia seem well positioned, in our view, to seize these new opportunities.

Furthermore, **solar panel and turbine manufacturers** such as First Solar, Shoals, Nextracker and Vestas **are benefiting from the rising demand for clean energy**, as tech industry players have pledged to achieve ambitious targets on low carbon electricity. The latter are prepared to pay a premium to secure their supply of clean energy, driving up the long-term renewable energy prices negotiated with producers and distributors - known as Power Purchase Agreements (PPA).

Independent developers and producers of renewable energy, such as NextEra, Iberdrola, EDPR, Orsted, and Neoen are the main beneficiaries within our portfolio.

> ‘A change in the monetary cycle will be in our view an important performance catalyst for the energy sector’

RATE CUTS HAVE SHUFFLED THE CARDS

The ECB took a turn that had been largely anticipated by the market with the announcement of a first rate cut on June 6th. The Fed may follow suit in coming months. This new cycle will be an important performance catalyst for the energy sector, which is essentially made up of long-term assets.

In 2022 and 2023, **higher interest rates were clearly a headwind for environment-related stocks**, which were adversely impacted but are now poised to benefit from more favourable tailwinds.

ATTRACTIVE VALUATIONS

Despite the recent market rebound, the valuation premium displayed by environment-related stocks remains compressed relative to its 5-year history (roughly a 10% premium over the 12m forward P/E ratio for the MSCI Europe, and 0% for the MSCI World[1]).

Environment-led stock and small and mid-caps are two categories that suffered from large outflows over the past two years. **The downside pressure now appears to be decelerating and has even begun to revert for small & mis-caps.**

Finally, investor exposure is at all an all-time low, reflecting a high level of scepticism which could develop into a genuine opportunity. We believe that despite the volatility brought about by the US elections, short sellers could begin to reduce their positions, leaving room for traditional and tech investors who are considering strengthening their long-term exposure to the Environment theme.

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[1] Source : Bloomberg; Sycomore AM. Data as of 29/05/2024.

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