

European Utilities - the Long, the Short and the Green

Stockholm (HedgeNordic) - This week, we had the opportunity to sit down over lunch with Eric Melloul, European utility specialist at New York-based Electron Capital Partners, a long/short hedge fund manager focused on global utilities and infrastructure. Our discussion took us around the different opportunities for investing in liquid utilities and infrastructure in Europe and beyond, with a particular focus on the long-term changes related to environmental concerns, and the need to adapt to a growing world population.

Melloul previously held a position at the large asset management house TIAA, a precursor of sustainable investing in the US, where he managed US\$1.3 billion across three internal sector funds. At Electron Capital, which he joined last year, the team doesn't claim any label of sustainability, at least not yet. Given the investment universe, the fund is concentrating on, however, environmental concerns and associated trends are inevitably intertwined with stock picking.

In utilities and infrastructure, Melloul explains, the primary investment themes have been driven by technological innovation, which has led to disruptions, and government-driven policy changes. In Europe, the push towards decarbonisation is showing in the numbers. "Only a few days ago," Melloul mentions, "think tanks Agora and Sandbag published a report showing that five years ago, the power generated by wind, solar and biomass was less than half of that generated by coal in the European Union. Last year, the former has surpassed the latter for the first time. In 10 to 15 years, coal-generated power will cease to exist in virtually all Western European countries, and it is also highly likely that within one generation the vast majority of countries will have stopped building new coal-fired power plants."

Some countries have set firm deadlines for their zero-coal target, but in the past, such decisions were not always made on realistic assumptions. Melloul explains: "Sometimes, public policy shifts are the consequences of decisions that are not fully contemplated. To reach their zero-carbon target within the planned timeframe, governments will have to rely on different technologies, as intermediary solutions. We expect a mix of hydropower, batteries and gas-generated power." While gas is also a fossil fuel, emissions can be a third of those generated by coal. "It is interesting to see that the US is reducing its emissions drastically, as they are switching from coal to gas. Economic reasons essentially drive this trend, but the associated effect is positive for the environment," Melloul points out. "In fact, gas is so cheap that it is increasingly pushing nuclear out of the system as well. Some States are introducing the idea of Zero Emission Credits (ZEC), an incentive to subsidise the running of nuclear power plants."

"The French government is committed to shutting down coal by 2021, and they want to reach this target while initiating a reduction of nuclear at the same time," Melloul continues. "Will they use gas? Or will they bypass this technology altogether? We expect that offshore wind is one of the answers to the question." Melloul refers to the UK, Netherlands and parts of Scandinavia, which benefit from vast reserves of high-speed offshore winds. "This is a very scalable source of energy, and the cost curve is coming down very quickly. At Electron, we have already seen this trend for solar and onshore wind, where prices have fallen much faster than expected. We observe some super-competitive tenders in Chile, Brazil and Mexico, with prices at rock bottom levels."

Offshore wind can already provide good returns. Danish windfarm operator Ørsted, previously known as Dong Energy, was the first company to win a project without any public subsidy. "Ørsted

was one of our key holdings throughout 2017. We were very enthusiastic about global leadership they have and could maintain in the offshore market. Over the next 20 years, we expect that the offshore market could grow seven to ten folds.”

Typically considered a somewhat dull and slow-growing industry, utilities are under the influence of some exciting trends. Critical technological changes will take place all the way into people’s homes. “Consider to what extent a battery in your home can turn into a mini-utility,” proposes Melloul. “New paradigms of consumption and transaction are developing in the energy industry. Imagine, hypothetically, that you are working from home today. If your smart system at home is aware of that, it may be able to decide that your electric-car battery doesn’t need to be charged at 100% and can sell off some of that energy. If it is a day with low wind, for instance, the system may use that power and give you a good price for it. Blockchain technology is one of the solutions the industry is looking at to automate more efficiently how electrons move in and out of the house.”

The world’s population is expected to reach up to 10 billion by 2050, Melloul reminds us. “This increase will be accompanied by a strong urbanisation trend, which translates in a higher population density. Utilities will face challenges, regarding energy needs, but also water purification and waste management systems. The idea of a circular economy will be more important than ever. Parts of the waste management solution will be the recycling of waste into packaging materials for example and energy generation.”

Could such strong positive trends also translate into short ideas for a hedge fund like Electron? Melloul assures us that there are plenty of opportunities for tactical shorts. The market is very efficient in pricing in industry laggards, for example, so there are not many low-hanging short candidates. However, for an industry specialist like Melloul, opportunities appear when policies change for instance. “Take as an example the situation that arose after the Fukushima catastrophe. Angela Merkel decided that Germany should exit nuclear as a power generation technology. She immediately forced the sector to shut down about half of the nuclear capacity. Of course, this decision strongly impacted the owners of the nuclear fleet. Governments actions can sometimes put some companies at a bigger disadvantage than others.”

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