Renewable energy

Good companies, but are they good investments?

Wealth Management
Dominion Securities

Investing in the renewable energy sector over the past several years has definitely not been for the faint of heart. While the long-term prospects of renewable energy are arguably quite favourable and there are definitely good companies in the space, does that necessarily mean these good companies make good investments?

In this report, we dive into what has been driving renewable energy share prices, the increased competition from non-pure-play renewable energy companies, what U.S. President Joe Biden's climate plan means for Canadian players in the space, and ESG (Environmental, Social, and Governance) considerations.

Price performance

We will focus on the S&P/TSX Renewable Electricity subindex, whose constituents include five major Canadian public renewable energy companies.

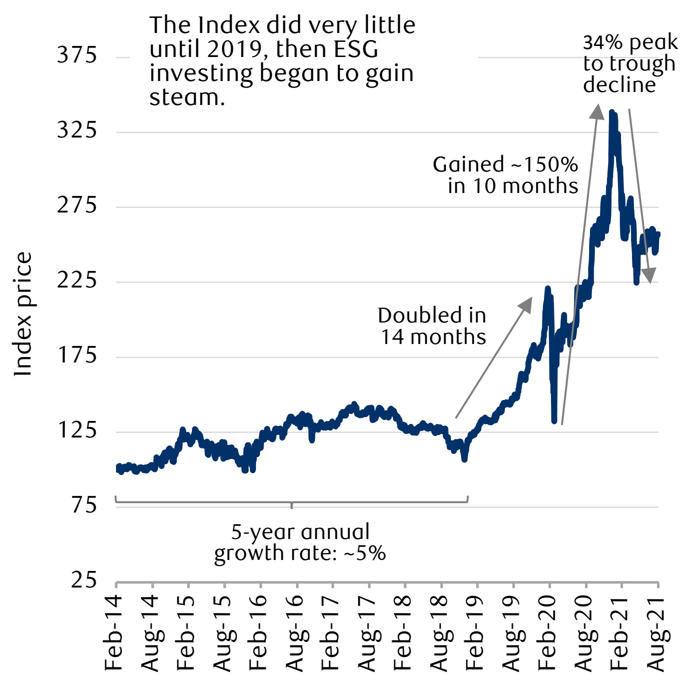
As the price chart at right shows, volatility in renewable energy stocks increased significantly in late December 2018, with the Index doubling over a period of approximately 14 months to a pre-pandemic peak on Feb. 19, 2020. This is a remarkable contrast to the Index's annual rate of return of around 5% for the five years following its inception in February 2014.

The pandemic-driven selloff that followed this peak took approximately 40% off the value of the Index from peak to trough, which was slightly worse than the S&P 500 (-34%) and the TSX (-37%). However, the ascent that followed was even more dramatic than the first. Over a span of roughly 10 months, the Index rose approximately 150%—more than twice the return of the S&P/TSX Composite and the S&P 500.

Unfortunately for renewable energy investors, that rally also faded, with the Index declining 34% from peak to trough between Jan. 8 and May 12, 2021, while the S&P 500 and S&P/TSX Composite were both up 6% over the same period.

Renewable electricity suddenly gets "interesting"

S&P/TSX Renewable Electricity subindex performance



Source - RBC Wealth Management, FactSet; data through 8/31/21

Growth versus multiple expansion

We believe many investors justified the higher renewable valuation multiples after late 2018 based on prospects for growth well beyond what was in the pipelines of the major producers. Today, however, it seems that investors are no longer giving the same level of credit to these prospects as they did earlier this year.

All values in Canadian dollars and priced as of Aug. 31, 2021, market close, unless otherwise noted.
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According to Bloomberg data, average revenue and earnings growth for the S&P/TSX Renewable Electricity sub-index from its inception to mid-2020 were in the 10%–12% range, with little in terms of volatility in either metric along the way. These growth rates pale in comparison to the price growth rates discussed above. Thus, in our view, the volatile moves in renewable energy stocks over this period can be attributed largely to multiple expansion/contraction.

It is also interesting to note that the significant increase in assets under management by ESG-focused ETFs since 2020 (see charts at right) largely coincides with the rapid appreciation of renewable energy stocks. As shown in the table on the next page, four of the five major Canadian renewable energy names in the S&P/TSX Renewable Electricity subindex made the Top 20 list for Canadian stocks held in actively managed sustainable equity funds at the end of Q2 2021. However, a closer look at the remaining constituents of this list (mostly companies in the Financials, Industrials, and Technology sectors with large market capitalizations) argues that from a sustainability perspective, the universe of investable options in Canada is quite limited.

Competition

While there are really only a handful of pure-play Canadian renewable energy companies to choose from, investors should be aware these firms face competition from private companies and non-pure-play companies both here at home and globally.

Oil & gas producers and energy infrastructure companies are becoming more active in this space, helping to drive the energy transition by making investments in low-carbon power generation such as wind, solar, and hydrogen power.

Several global oil majors—including Total SE, BP, Repsol, and Royal Dutch Shell, to name a few—have already made sizable investments in renewable energy production, and demonstrated their ambitions to continue growing in this area over the years and decades to come.

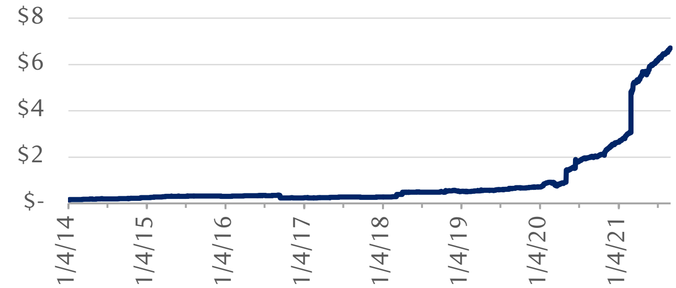
Closer to home, Enbridge, Suncor, and Algonquin Power are examples of players outside the pure-play renewables space that are actively growing their renewable energy businesses.

Enbridge Inc. (ENB) has been investing in renewable energy since 2002, and has committed more than $7 billion to renewable energy and power transmission projects currently in operation or under construction. The company's renewable energy projects have gross generation capacity of over 5,000 megawatts, making Enbridge one of the largest renewable energy companies in Canada. Investments include 23 wind farms, seven solar energy operations, and one hydroelectric facility, amongst others.

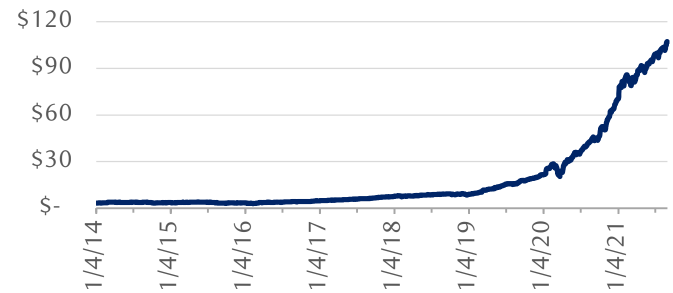
A growth spurt for ESG funds

Assets under management (AUM) in ESG-focused exchange traded funds

Canadian ESG-focused ETF AUM (billions of Canadian dollars)



U.S. ESG-focused ETF AUM (billions of U.S. dollars)



Source - RBC Wealth Management, Bloomberg; data through 8/31/21

Suncor Energy (SU) has four wind power projects in operation with a total capacity of over 100 megawatts, and is currently evaluating solar energy investment opportunities. In addition, Suncor and ATCO Ltd. recently announced they are collaborating on early-stage design and engineering for a potential clean hydrogen project near Fort Saskatchewan, Alberta. The project would produce more than 300,000 tonnes of hydrogen per year.

It is important to note that not all energy producers are racing to develop their own renewable energy generation capabilities. Several large Canadian oil producers have stated as much. Rather, these companies have long-term strategies in place to reduce emissions through initiatives such as carbon dioxide (CO_2) capture and sequestration, carbon conversion, methane emission reduction, use of natural gas as an energy source, and the reduction of flaring and venting.

Algonquin Power & Utilities (AQN) is primarily a regulated utility, but a growing part of its business is centered on the acquisition and operation of green and clean energy assets. Algonquin's power-generation division directly owns and operates facilities with a total renewable energy generation capacity of roughly 2,500 megawatts, including wind, hydro, and solar power. The company has set a goal of 75% of production across its power generation and regulated utility divisions from renewable sources by 2023, compared with roughly 46% in 2019.

It's a small world after all

Top 20 Canadian stocks most widely held in actively managed sustainable equity funds

Ticker	Company name	Sector	% of sustainable funds owning
SHOP	Shopify Inc. Class A	Information Technology	10%
BLDP	Ballard Power Systems Inc.	Industrials	8%
TD	Toronto-Dominion Bank	Financials	7%
CP	Canadian Pacific Railway Ltd.	Industrials	7%
BEP.UN*	Brookfield Renewable Partners LP	Utilities	7%
STN	Stantec Inc.	Industrials	6%
MFC	Manulife Financial Corporation	Financials	6%
BNS	Bank of Nova Scotia	Financials	6%
NPI*	Northland Power Inc.	Utilities	6%
BLX*	Boralex Inc. Class A	Utilities	6%
RY	Royal Bank of Canada	Financials	5%
CNR	Canadian National Railway Company	Industrials	5%
IFC	Intact Financial Corporation	Financials	5%
INE*	Innergex Renewable Energy Inc.	Utilities	5%
BMO	Bank of Montreal	Financials	5%
WCN	Waste Connections Inc.	Industrials	5%
LUN	Lundin Mining Corporation	Materials	4%
H	Hydro One Ltd.	Utilities	4%
WFG	West Fraser Timber Company Ltd.	Materials	4%
WSP	WSP Global Inc.	Industrials	4%

* Major Canadian renewable energy companies.

Sustainable fund ownership statistics as of Q2 2021; based on RBC U.S. Equity Strategy's universe of actively managed global, EAFE (Europe, Australasia, and Far East), and Canadian-focused dedicated sustainable equity funds, representing US$353 billion in assets under management.

Source - RBC U.S. Equity Strategy, Morningstar

Development returns

In general, returns for renewable energy projects have trended lower over the past decade. RBC Capital Markets estimates the levered equity returns for wind and solar projects have declined from the mid-to-high teens a decade ago to around 8%–10% or lower today. As an example, consider a U.S. solar portfolio acquired by a Canadian renewable energy producer in November 2020; RBC Capital Markets estimates the portfolio will generate a levered after-tax equity return of only about 6% (before potential synergies) despite an initial capital structure using 75% debt.

Required development returns have trended lower as a result of multiple factors, including lower interest rates; increased ability to borrow debt at a lower cost at the project level; the maturation of the industry, which has reduced construction risk and made solar and wind generation more predictable; increased competition (pension and infrastructure funds bidding up the price of assets); and greater attention to ESG considerations.

President Biden's climate plan

According to a report by RBC Capital Markets, the greatest growth opportunity for Canadian renewable energy producers lies in the U.S. This is because Canada's grid is already quite green, with more than 80% of electricity generated from non-carbon-emitting sources including roughly 60% hydro and 15% nuclear.

This is a stark contrast to the U.S., where 62% of the generation mix in 2019 was from gas and coal, providing more greening opportunities. RBC Capital Markets estimates that the pace of renewable energy deployment in the U.S. may need to at least triple over the next decade in order to meet President Biden's climate plan targets. Most Canadian renewable energy developers have entered the U.S. market over the past several years to take advantage of these opportunities.

ESG risk view

According to our ESG research provider, Sustainalytics, renewable energy generators typically have lower exposure to environmental risks than do companies that rely on fossil fuels.

However, this does not mean there are no risk exposure issues to consider. Sustainalytics notes that hydroelectric projects are often opposed by local communities due to potential relocations and negative impacts on biodiversity, and this can result in added costs and delays. Hydro projects also have the potential to disrupt existing waterways or increase lowland flooding. Oil leaks from wind turbines can pollute soil and water, exposing companies to retrofitting and clean-up costs as well as potential fines.

Conclusion

While Canada appears to be ahead of the game with respect to renewable energy generation, in our view, the shift towards greater reliance on green power is still in its early stages on a global level. We believe renewable energy equity investors have gotten ahead of themselves on a few occasions over the past several years, but the recent weakness has made valuations *relatively* more reasonable.

For those looking to gain exposure to Canadian renewable companies, we would recommend focusing on those with healthy U.S. and/or global opportunities that should provide the ability to compound capital over the long term. In our view, fits and starts in the sector such as we've seen in recent years could very well continue, so investors in the space are well advised to exercise patience, select the "best-in-breed" names, and be willing to add to their positions in stages as valuations could be subject to further multiple compression in the near term, despite what we view as favourable longer-term prospects.

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