VH Global Sustainable Energy Opportunities

GSEO: a unique global portfolio of assets critical to the energy transition...

Update
11 September 2024

Overview

VH Global Sustainable Energy Opportunities (GSEO) is a global renewable energy infrastructure trust specialising in assets relating to the global energy transition, with the current portfolio focussed on the US, UK, Australia and Brazil. GSEO's target return of over 10% is higher than average for a renewable infrastructure trust and reflects that it may take on projects at the construction phase as well as operational assets with scope for active management.

As well as geographical diversification, the portfolio is also diversified compared to peers in terms of the technologies and stages of energy transition, such as fuel storage, flexible generation or co-located solar and battery storage assets, and with a bias to assets where there is a construction or expansion angle, or a financial or operational optimisation opportunity. The current portfolio is concentrated, with the largest three assets valued being 50% of NAV. Over time this concentration should reduce as other assets in the portfolio go through further construction and expansion, with resulting increases in value.

The trust is managed by Victory Hill's co-chief investment officers Richard Lum and Eduardo Monteiro. They lead a team of eight experienced investment professionals, with the single focus of managing GSEO.

GSEO yields 7.6%, and has a progressive dividend policy, supported by the fact that 90% of cashflows have some form of inflation link. The dividend is fully covered, and GSEO has very little gearing, c. 2%, and this is all secured against GSEO's largest asset, meaning that the dividend does not rely on gearing, nor do higher interest rates present a challenge to the cover.

GSEO trades at a c. 35% discount, wider than the peer group average of c. 23%, and the board has instigated an active share buyback programme, which we chart in the **Discount section**, which will enhance both the NAV and earnings, and potentially alleviate the discount.

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Analyst's View

While the path to lower interest rates now seems a bit clearer, the challenge that many renewable energy infrastructure trusts now face is that the accompanying return to regular-as-clockwork new capital raisings seems like a much longer journey, and many are now pivoting business models to suit more austere times. GSEO's strategy has, from inception, been centred on projects with scope to enhance earnings through a variety of means, such as operational or contractual improvements, or by taking some construction risk to expand or roll out projects. While this still requires equity, the amounts are smaller than required to purchase fully operational assets. The team's decision not to employ gearing in most projects gives greater flexibility in this respect, as they could now choose to use small amounts of gearing instead of equity to move the existing portfolio along.

The combination of, on the one hand, GSEO's minimal gearing, combined with its position higher up the risk curve than some of its more traditional peers that principally focus on efficient operation of assets, together with its wide discount make for an interesting proposition from both and income and capital perspective. First, with the caveat that this is an estimate, the team believe completion of their existing programme of construction might increase dividend cover to 1.5x, and second, moving from construction to operational results in an increase in NAV. At a point in the cycle when investors may well be looking to add more risk, rather than reduce it, GSEO could be a very attractive alternative.

BULL
Exposure to energy transition through a portfolio unlike any other in the peer group
Low gearing gives management greater flexibility on future funding requirements
Wide discount and high and covered yield may provide a floor to the share price

BEAR
Portfolio is concentrated in comparison to the peer group
While construction projects offer greater upside potential, they can be riskier
Sector-wide sentiment remains weak

Portfolio

GSEO's portfolio of assets provides investors with exposure to a portfolio that is very different from a 'standard' renewables trust. Rather than the traditional focus on operational wind and solar assets, GSEO's main geographical exposure is to the US, Brazil, Australia and the UK, across solar and battery storage, fuel storage, gas turbines with carbon capture and reuse and hydropower. This range of geographies and technologies is distinct within the peer group and reflects the team's approach to identifying assets in the energy transition chain that are less obvious and so less subject to price competition. We discuss the fuel storage asset later in this section, as at first glance this stands out as unusual, but has a clear rationale. It's important to state up front that GSEO has a very concentrated portfolio, with three assets making up c. 60% of the value. Even without further acquisitions, this is likely to change over time as assets at the construction phase become operational and increase in value as a result.

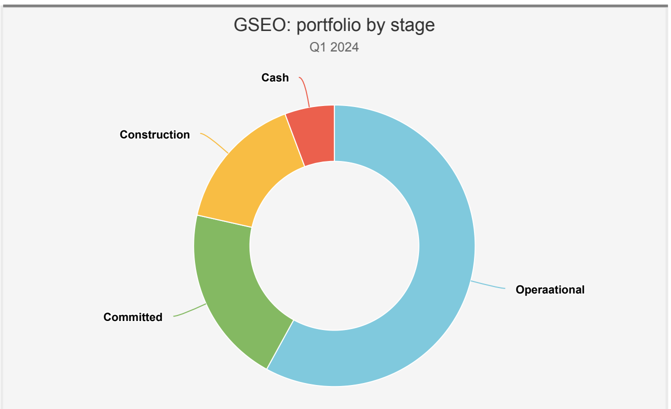
As well as seeking assets in less competitive niches, the team aim to purchase assets with a combination of asset and operational management opportunities, while at the same time are willing to consider assets in more unusual parts of the energy transition chain, which potentially see less asset price competition. Several times in this note we refer to GSEO taking construction risk and it's important to set out at the start that this is one step on from development risk. GSEO doesn't invest in speculative projects but does invest in projects where there is either a remaining construction phase, or scope for expansion for further construction. In addition, 'construction' in the context of the types of assets that GSEO owns is a relatively simple process compared to, say, building an office, given that it is largely about installing equipment such as solar panels or batteries on a simple outdoor site.

The reason we think construction could be important is that one of the key questions for investors, and managers, in the listed renewables infrastructure sector is around equity funding. After a long period of reliable equity raising, GSEO and its peer group are trading at wide discounts, effectively closing the door to new equity fund raising. One of the challenges within this is that many trusts in the peer group have used leverage to bridge their acquisition strategies in between equity fund raising and have been left with relatively expensive short-term debt that wasn't intended to be drawn for very long. Thus, we see some selective asset disposals and pivoting to investment strategies of taking more construction or even development projects, which, while riskier, require less capital than acquiring fully operational assets. GSEO has not had to undergo this kind of pivot in its own business model, as taking construction risk was baked in from inception, nor has it faced making a choice about repaying expensive debt.

A further advantage GSEO has entering this period of higher rates and a hiatus for new equity raising is that it has used almost no leverage, and all the assets it owns were specifically targeted for the opportunities to build out the projects. The team look for projects with elements of construction, or where changes to the structure of the project may increase revenues, for example co-locating energy storage with renewable energy generation or introducing 'private wire' arrangements where power is supplied direct to a commercial customer, rather than being fed into the grid, with a direct long-term power purchase agreement.

There are a number of ways to break down GSEO's portfolio, and several of those are shown in our last note, which you can **read here**, and although the precise numbers have changed a little, they still give a relevant picture two quarters on. We want to focus here on one aspect of that, which we think is key for investors considering GSEO's large discount and wondering what the potential catalyst for it to recover could be. The chart below shows the portfolio broken down by stage, with just under 60% of the portfolio operational, c. 20% committed and c. 16% at construction phase. If we consider that GSEO is yielding c. 7.8% at the share price, with the dividend covered, and only 60% of the portfolio is operational, then it's not hard to see where potential returns could come from. Construction assets are held at cost, so as well as the enhancement to earnings there is potential for an increase in valuation at the point they become operational. Further, as we discuss in the **Performance section**, despite only 60% of the portfolio being fully operational, the trust is already on track to meet its return targets.

Fig.1: Portfolio By Stage



Source: GSEO

GSEO's largest asset, c. 25% of the portfolio, is an excellent example of a part of the energy transition that few investors will have stopped to consider. This is a US-based fuel terminal that sits in a crucial location that provides storage for Mexico's largest oil company to ship high sulphur fuel to the United States for reprocessing, in order to reduce the environmental damage caused by air pollution in Mexico. Addressing air pollution has been identified by Mexico as a central goal in its energy transition strategy and the team note that currently the most effective way to 'clean' petroleum is at Pemex's US refinery. To be clear, GSEO's terminal isn't doing any of the processing, it's just in the right location in the chain to supply Pemex with storage facilities, and it has a rolling inflation-linked contract to do so.

This facility was acquired with a storage capacity for 500K barrels, and the team has already undertaken a project to expand this to 800K. A third of the physical site remains underdeveloped and there is scope to build capacity up to 1.25m barrels. This asset is the only one in the portfolio currently employing gearing, but this is at a very low level and it would be quite possible to employ more borrowings to help fund an expansion project, with lenders likely to be more willing to lend as value-creation initiatives start to generate revenue. As a general comment, the team haven't yet seen borrowing costs start to fall but have seen a pickup in willingness to lend, which could well be the precursor to a reduction in borrowing costs. We'd conclude by saying that the asset is fully operational, and that's the basis of its valuation, so the prospect of additional capacity isn't priced into the valuation, so the team can choose the right time to push forward with this.

GSEO's solar assets in Australia, c. 11% of the portfolio, also provide a good example of an opportunity to expand a project through construction, using a creative approach. In the team's view, Australia's quite disorderly approach to energy transition is increasing demand from private commercial customers for direct purchase of power to give them certainty of supply, and GSEO's solar assets are being configured to provide private wire arrangements, using a mixture of solar PV and battery storage. These assets can therefore be attached to a long-term power purchase agreement, but also have the option to utilise storage capacity to generate additional merchant revenues from trading intra-day power price fluctuations. There are seven sites in this project, of which two are fully operational, two have operational solar with energy storage in the construction phase, and two where all elements are under construction, and the project provides a good case study of where the team can add value both to operational assets, through reconfiguring for storage and private wire, as well as in completing construction phases.

To illustrate that moving from construction to operational isn't a distant prospect, GSEO's UK assets, consisting of flexible gas generation combined with carbon capture and reuse equipment are expected to complete commissioning before the end of 2024. Flexible gas generation is an acknowledged pragmatic solution to the issues created by the grid's greater reliance on intermittent renewable energy sources, and GSEO's assets will capture the resulting CO_2 and purify it for sale to the food industry, which currently relies on CO_2 manufactured using very energy intensive techniques. This means the assets will have a positive impact on Scope 4 emissions (in simple terms, Scope 4 emissions are indirect emissions that have been avoided as a result of GSEO's direct actions).

Recently, in July 2024, the team announced a new investment in a solar and wind portfolio spread across Spain, Portugal and Sweden. This is a two phase investment structured as a co-investment, with the first phase being the acquisition of an operational portfolio of five solar and wind assets across those three countries, generating c. 60MW, together with four further ready-to-build solar PV assets in Spain. The second phase involves the construction of c. 188MW of solar generating capacity, with construction to be funded by the co-investor and project finance.

On completion, GSEO will be the largest owner with 43.5% of the equity in a portfolio with a generating capacity of c. 248MW of which 100MW is already operational. The introduction of co-investors illustrates that GSEO has more options than simply building out projects on its own, with the overall equity investment being c. €98m of which GSEO is providing €53m. The project will be geared so once completed will slightly increase GSEO's exposure to underlying gearing, which, as we discuss in the **Gearing section**, is currently very low.

Finally, when thinking about long-term returns, one very interesting observation the team made recently was that they feel that current power price forecasts aren't yet taking the potential rise in demand for AI systems into account, when we already know that the technology that powers AI is particularly energy-hungry, and so there could be significant upside to power demand and prices compared to current forecasts, as well as even greater need for flexible power and energy storage systems.

Gearing

GSEO currently has gearing equivalent to c. 2% of NAV. As noted in the **Portfolio section** this is all secured against the trust's largest asset, rather than being secured at top company level, and so the rest of the portfolio is free of debt. As we discuss in the **Discount section** GSEO's low gearing gives it more flexibility than many in its peer group, which are typically much more geared, when considering share buybacks. With GSEO's portfolio assets typically owned for their expansion potential, some additional gearing could also provide the funding to do this at the right moment. In the **Portfolio section** we discuss a very recent investment that in time will introduce a little more gearing.

Should GSEO choose to introduce more debt, its formal borrowing policy has two limits:

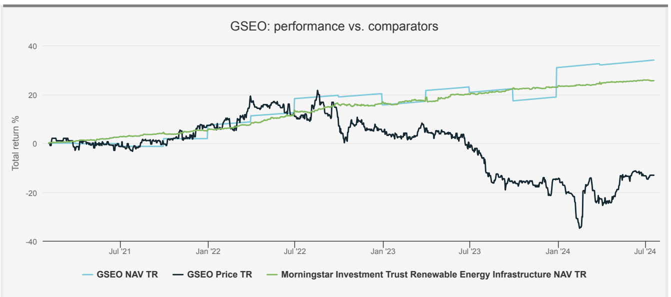
- First, that limited recourse debt, i.e. the type of debt discussed above that it applied to individual assets, is in aggregate limited to 60% LTV
- Second, that any debt at the top company level, which would be shorter term debt used, for example, to help fund acquisitions, is limited to 30% LTV.

We emphasise that these are policy limits, and there is no current intention to use gearing up to these limits.

Performance

GSEO's NAV total return since its launch in February 2021 is c. 34% and its share price TR over the same period is -13%, which is a function of the very wide **Discount** that has developed in the last two years. The Morningstar renewable energy infrastructure peer group's NAV total return over the same period is c. 26%. This is shown in the chart below, which illustrates the point at which the share price departs from the NAV is associated with the interest rate cycle, rather than a specific comment on GSEO by the market.

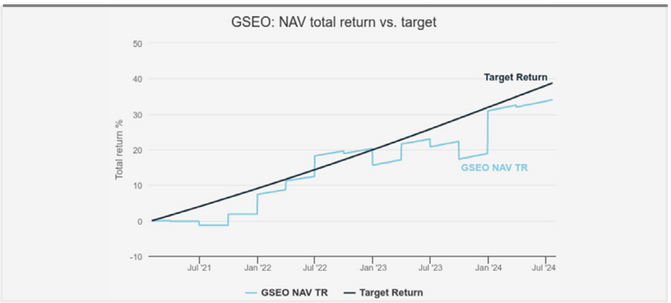
Fig.2: Performance Since IPO



Source: Morningstar , as at 19/07/204
Past performance is not a reliable indicator of future results.

GSEO has a target return of greater than 10%. In our view the period since IPO in 2021 is too short to get a full picture, particularly as a reasonable proportion of this timescale involved acquiring assets from an initial 100% cash position. Nevertheless, this is the target return and thus is effectively GSEO's benchmark, so we chart the NAV total return against a 10% hurdle below, and while it is technically true that the total return is slightly below the hurdle, our view is that this chart shows that the trust is on track to deliver this target over a longer period. In the **Portfolio section** we discuss that the team's strategy has the potential to deliver higher returns from the existing portfolio without having to rely on new acquisitions.

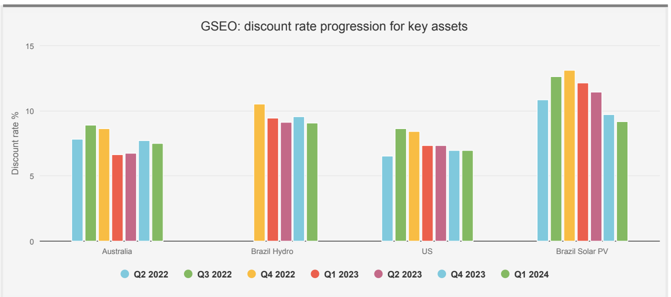
Fig.3: Performance Against Target Return



Source: Morningstar , as at 19/07/204
Past performance is not a reliable indicator of future results.

The team take a dynamic approach to valuing assets, adjusting discount rates quarterly according to changes in inputs, such as inflation assumptions and country risk premia, and discount rates for each operational asset are disclosed. The chart below plots how those have changed for each asset. We note that GSEO's single largest asset, in the US, has seen a relatively stable discount rate for the last four quarters and at the time of writing a rate cut in the US looks increasingly likely, which has positive implications for performance.

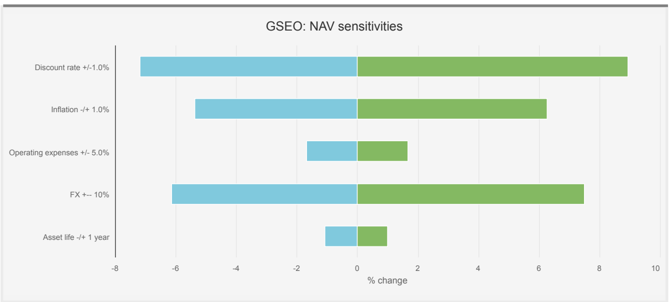
Fig.4: Changes In Discount Rates



Source: GSEO
Past performance is not a reliable indicator of future results.

Again, the main sensitivities summarised below don't capture the upside potential of construction assets but give a sense of how GSEO's operational assets respond to various inputs. It's worth noting that FX rates are an unusually large sensitivity compared to much of the peer group. This is a simple function of GSEO's global mandate and the fact that most of its assets are not in the UK. In the first half of 2024 sterling has been stronger against most currencies including the US dollar, perhaps a reflection of the UK's shift to a stable political position as well as due to the attractive valuations of UK equities causing more inflows. Investors looking with interest at GSEO's discount to NAV can also consider that the trust is also cheaper for a sterling investor as a result of this stronger currency, although, of course, as GSEO is unhedged, if sterling weakens this would impact returns (this is, though, a very routine risk borne by an investor in any fund or trust that invests overseas, so we emphasise this is not an idiosyncrasy of GSEO, just that it is unusual in its peer group).

Fig.5: Key Sensitivities



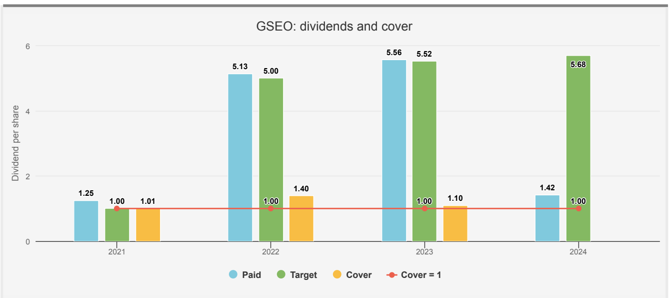
Source: GSEO, as at 31/12/2023
Past performance is not a reliable indicator of future results.

Dividend

GSEO currently yields c. 7.6%. The trust pays dividends quarterly and has a progressive dividend policy, aiming to increase the dividend each year. Total dividends for the previous financial year to 31/12/2024 of 5.56p were slightly ahead of the target of 5.52p. GSEO's board set a target dividend for the year ending 31/12/2024 of 5.68p and reaffirmed this at the first interim dividend stage in April 2024, declaring a 1.42p dividend. GSEO's IPO was in 2021 and so the chart below shows how the dividend has ramped up from launch as cash was gradually invested into income-producing assets.

The scope in the **Portfolio** for further construction and operational improvements provides a potential pathway to increasing earnings and hence dividends and within the current portfolio the team believe dividend cover could increase to between 1.4 and 1.5x when all assets currently under construction are completed.

Fig.6: Dividends And Cover



Source: GSEO
Past performance is not a reliable indicator of future results.

Management

Victory Hill is a specialist investment firm based in London targeting direct investments in global energy infrastructure that support the UN Sustainable Development Goals, with the aim of facilitating an orderly energy transition to a net zero carbon future. GSEO is the team's sole focus.

Richard Lum and Eduardo Monteiro are co-chief investment officers of Victory Hill and lead the team managing GSEO. Before founding Victory Hill in London in 2020, Richard and Eduardo worked together for several years in investment banking, specialising in energy and natural resources.

Richard has over 30 years of experience in energy and natural resource banking, principally in project, corporate and structured finance. Before founding Victory Hill, he was global head of energy origination at Mizuho Bank in London. Focussing on public and private capital raising and securitisation opportunities across the energy value chain, he was involved in transactions worth c. US$15bn. Prior to his role at Mizuho, Richard worked in the global energy structured finance group at WestLB Markets in London, and he began his career at Standard Chartered Bank based in Kuala Lumpur and London, where he spent seven years focussed on emerging markets coverage and the financing of power and infrastructure projects in the Far East, South Asia and Africa.

Eduardo also worked at Mizuho, where he headed the natural resources corporate finance team covering the EMEA region and working both equity and debt transactions including IPOs, M&A and debt structuring. Prior to Mizuho he worked in M&A at Société Générale and at ABN AMRO/RBS in Sao Paulo and London. He started his career at JP Morgan in Sao Paulo.

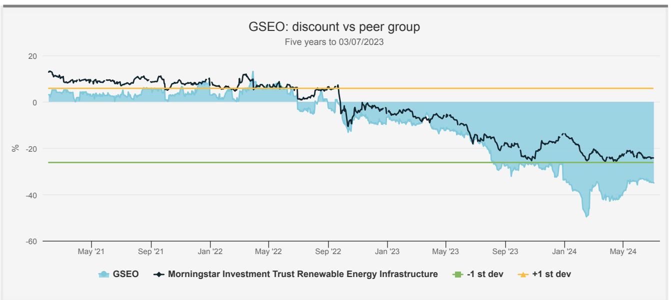
Richard and Eduardo are part of a team of 18 professionals, covering areas such as legal, finance, operations, risk, compliance and investor relations.

Discount

GSEO's discount of c. 35% is wider than the average for the renewable energy infrastructure peer group of c. 23%, but there are a couple of things to consider. First, the peer group average is influenced by some very large trusts with very stable operational asset portfolios with relatively straightforward valuations. Second, the chart does clearly show that GSEO's discount has tracked the wider peer group trend very closely, and in our view the main reason for GSEO's discount is macro, as it is for the rest of the peer group. Aside from the obvious macro factor of higher interest rates, GSEO and its peers' discounts have been influenced by their relatively narrow group of institutional shareholders managing multi-asset funds, which as a group have put pressure on discounts by selling in order to either trade into corporate bonds or to fund redemptions, as their own investors do the same. Aside from the turn of the interest rate cycle setting a more positive tone, the other key to unlocking discounts is for this to reverse, or for a different group of investors to start buying.

A further possible factor in GSEO's discount is the recent announcement that its largest shareholder, Witan (WTAN), is merging with Alliance Trust (ATST). WTAN owns c. 13% of GSEO. This may have created a perception in the market of an overhang of GSEO stock. While one would naturally expect any shareholder to say little about their intentions, the messaging from ATST is supportive of the GSEO strategy, and notes that the discount does not reflect the progression the NAV and dividend have made.

Fig.7: Discount

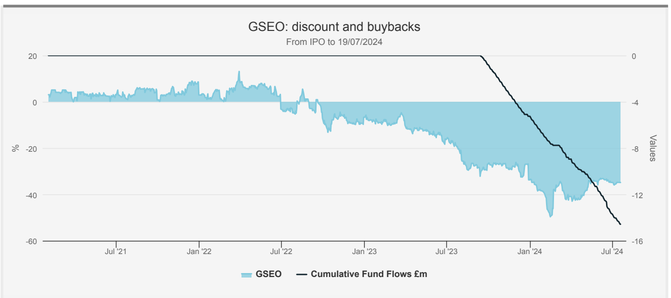


Source: Morningstar, as at 19/07/2024

The next chart shows GSEO's discount alongside a cumulative total for share buybacks. When the black line is descending, it indicates share buybacks, and when it is ascending it indicates share issuance. The chart clearly illustrates the board's response to the discount, with a steady series of buybacks, which the manager believes is among the most active in the peer group. GSEO's immediate peer group, and 'alternative' investment trusts more generally, mostly share the characteristic that underlying portfolios are private, unlisted assets that cannot be bought and sold at will in the way an equity portfolio can be. Therefore, share buybacks are a balancing act, with other factors to consider being retaining capital to invest in the existing portfolio and to make new acquisitions. With shares on a wide discount, the second of these is easier to assess, as a share buyback is in effect an acquisition of the existing portfolio at a discount to its valuation, and so any new acquisitions would have to match or beat that calculation. Investing in the existing portfolio is more nuanced as it may be about preserving as well as increasing value, and relatively small amounts of money could have a significant positive impact. The other balancing act is around gearing, and this is where GSEO is at a significant advantage, with many alternatives employing significant levels, and share buybacks have the effect of increasing gearing. Thus while GSEO does have to balance investing in the existing portfolio with share buybacks, gearing is a much smaller consideration. In any event, share buybacks executed thus far will have enhanced NAV and also enhanced dividend cover, as underlying earnings remains the same but the number of shares on which a dividend is paid will reduce each time shares are bought back.

GSEO has a five-yearly continuation vote, with the first of these to be held in 2026. This is a common shareholder protection that in normal circumstances provides a specific point in time where shareholders, the board and manager can discuss what, if any, changes need to be made, rather than a blunt instrument. It's not uncommon though to see very wide discounts narrow in the run up to continuation votes as there is often an expectation that a continuation will involve further action.

Fig.8: Discount And Buybacks



Source: Morningstar, as at 19/07/2024

Charges

GSEO has an OCF of 1.4%, which is in line with the 1.3% simple average for the AIC renewable energy infrastructure peer group. GSEO's most recent KID reduction in yield (RIY) is 1.65%.

GSEO has a tiered fee structure of 1% on the first £250m of NAV, 0.9% on NAV in excess of £250m and up to and including £500m and 0.8% on NAV in excess of £500m. At the time of writing, with net assets of c. £478m, our estimate of GSEO's blended management fee is c. 0.95%.

GSEO does not have a performance fee. There are some additional conditions attached to the fee that the manager must meet if the fee exceeds a certain amount:

- If the annual fee exceeds £3.5m, 8% of the annual fee, subject to a maximum amount of £400,000, must be used to subscribe for or acquire GSEO shares.
- If the annual fee exceeds £2.5 million, 2% of the annual fee will be paid to a charity aimed at promoting sustainable energy, as selected by the investment manager.

In the last financial year to 31/12/2023 the fee was c. £4.37m and therefore both these conditions were met and, given the wide discount, shares were purchased in the market to meet the first obligation.

ESG

GSEO reports under Article 9 of the Sustainable Finance Disclosure Regulation, and has Morningstar's highest ESG rating, which is a notable endorsement of GSEO's ESG reporting as Morningstar does not always rate investment trusts that own private assets due to the limitations of their ESG reporting.

Key to the team's approach is that as asset owners, they are able to directly influence each asset from an operational perspective and thus directly able to influence ESG performance. The team's approach to the energy transition is to recognise that some fossil fuel technologies, such as flexible gas generators, are key parts of transition, since they can replace less efficient technologies, such as coal, and also provide transitional support to the grid, mitigating the intermittency of renewable energy sources, and enabling the grid to rely more on renewable energy.

Some technologies GSEO invests in may also transition to burning greener fuels when these become available. As we discuss in the **Portfolio section**, GSEO's gas turbine assets employ carbon capture technology in order to mitigate emissions, and additionally the carbon dioxide is sold to the food and beverage industry, replacing other more energy intensive forms of production. Some ESG screens may show GSEO as having carbon risk, and for example, Morningstar's screens do not assign GSEO its low carbon rating. GSEO does, however, have the London Stock Exchange's green economy mark, which requires that companies must derive 50% or more of their revenues from green products and services. We would summarise their approach as pragmatic, since even the most optimistic pathways to net zero involve a significant transition phase, and with the addition of technologies such as carbon capture mean that many of GSEO's assets could continue to be relevant even in a fully transitioned world.

Overall, the team have a dedicated head of ESG and sustainability, but as a SFDR Article 9 fund with a specific impact objective, sustainability is integrated into every decision from acquisition through to operational decisions, rather than as an adjacent part of the process. Given that GSEO owns real assets and is the control investor, it is able to give very specific data in its detailed report contained within the annual report.

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