VH Global Sustainable Energy Opportunities

GSEO: Targeting the global energy transition...

Update
14 November 2023

Overview

VH Global Sustainable Energy Opportunities (GSEO) is invested in infrastructure assets relating to the global energy transition across several different countries including the US, UK, Australia and Brazil. The trust is managed by Victory Hill's co-chief investment officers Richard Lum and Eduardo Monteiro, who have worked together for many years before founding Victory Hill. They lead a team of eight experienced investment professionals.

The team aim to identify and acquire stakes in private assets involved in different stages of energy transition, such as fuel storage, flexible generation or co-located solar and battery storage assets where there is an additional angle such as further development or optimisation of the assets. The current portfolio is concentrated, with the largest three assets valued at over 50% of NAV, but this is expected to reduce as assets under construction become operational and, one would hope, increase in value. GSEO's target return of over 10% is higher than average for a renewable infrastructure trust, which is a reflection of the fact that it may take on projects at the construction phase as well as operational assets.

GSEO is net geared c. 2% with debt secured against a single asset. This means GSEO has very low direct exposure to rising interest rates and does not rely very much on gearing to enhance its dividend cover.

GSEO yields 7.1%, and has a progressive dividend policy, supported by the fact that 90% of cashflows have some form of inflation link. The trust trades at a c. 27% discount, following a trend of widening discounts across the AIC renewable infrastructure peer group. GSEO's board recently announced a share buyback programme for up to £10m. This will enhance net asset value and dividend cover, as well as providing additional liquidity to the shares and, potentially, help narrow the discount.

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Analyst's View

There are many moving parts to the global energy network, and we received a big dose of pragmatism in 2022 as energy prices spiked and gave us a reminder of how important fossil fuels remain as part of the energy transition. As a result, perhaps it seems more obvious now than it would have done five years ago why, for example, GSEO's fuel storage facility could be seen as a transition asset. GSEO invests in proven technology with a commercial track record, but seeks to find areas of the energy transition sector that are underappreciated and have greater scope for active management to make a difference.

This year we've been looking at how alternative assets, often originally owned by investors as 'bond proxies' during the zero-interest rate era, really need to be considered as a hybrid of bonds and equities, with the potential to generate real returns. In our view, GSEO is closer to the equity than the bond end of the spectrum, which is expressed through its higher target return, but this doesn't mean it doesn't have a strong backing of cashflows. The team have refrained from introducing gearing to all but one of the assets, and then only modestly. This means there is little risk from rising debt costs to GSEO's progressive dividend policy, and, when the interest rate outlook becomes clearer, gives it real options over whether to employ gearing against some of its maturing assets.

BULL
Fully covered, progressive dividend
Low net gearing gives flexibility on buybacks and future financing options
Inflation links and greater equity characteristics give potential for real returns

BEAR
Investor sentiment for alternatives is weak
Construction projects are more risky than operational projects
Current portfolio is concentrated

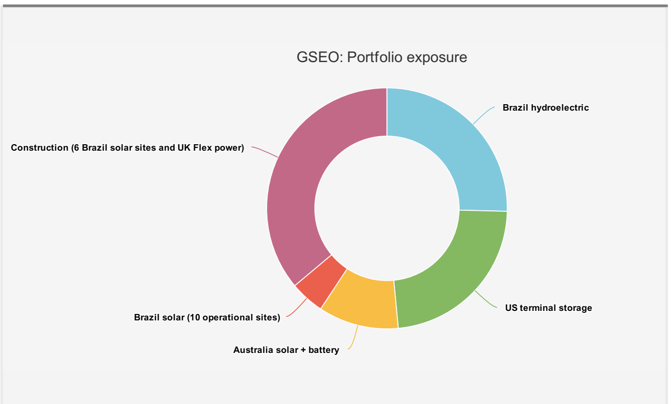
Portfolio

VH Global Sustainable Energy Opportunities (GSEO)'s portfolio is a portfolio of 26 privately held "energy transition" assets spread across four geographies, the US, Brazil, Australia and the UK. In total GSEO's portfolio is currently valued at c. £466m, and has exposure spread across five different technologies, being PV solar, PV solar co-located with lithium-ion batteries, flexible power generation with carbon capture and reuse, hydropower and terminal storage. GSEO is the majority and control investor in all assets. The portfolio is a mix of operational and construction stage assets, and at this point in the trust's development the portfolio is concentrated, with the three largest operational assets total c. 55% of the overall value. This is expected to change over time as construction projects are completed and, one would hope, achieve increases in value.

Operational assets provide the cashflow that covers GSEO's covered dividend, while construction assets provide the potential for greater NAV growth when assets achieve valuation increases as they move through the construction, commissioning and operational phases. Balancing the extra potential returns, construction-stage assets are higher risk than operating assets. On construction-stage assets, the only exposure the trust has to procurement and construction cost inflation is between making the decision, and entering into construction contracts. Once entered into, the price is locked and the only exposure GSEO has is to the credit risk of the contractor itself. Currently, GSEO is not exposed to any price increases, and all construction stage assets are fully funded to completion. The team believe there is no material risk from contractor's creditworthiness.

GSEO's portfolio is concentrated: the three largest assets, which are all operational, form c. 59% of NAV, being a US fuel storage terminal, a Brazilian hydropower project and a programme of 10 Brazilian solar PV projects. Construction assets are typically held at lower valuations, usually at cost, as a reflection of their higher risk, and so over time one would expect the assets currently at this phase to become a larger part of the portfolio as valuations increase to reflect the lower risk once they become operational. The first chart below shows the portfolio assets by current value, which illustrates its concentrated nature.

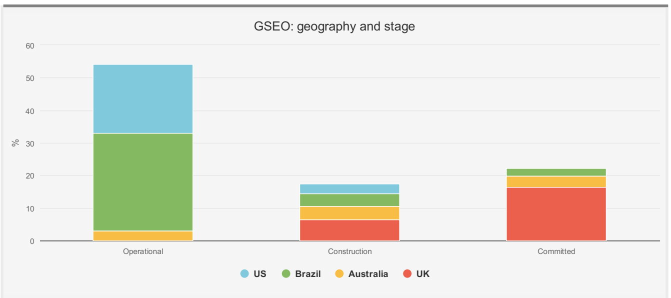
Fig.1: Portfolio Exposure %



Source: GSEO, as at 30/06/2023

The chart below summarises the breakdown of assets in terms of geography and stage. The chart shows operational and construction assets, as well as further commitments, which are binding commitments to either further funding for existing investments, or to new investments. All the commitments are fully funded by cash held against them, which is not included in the net cash figure, which is a measure of cash remaining once all commitments are fulfilled. As is common in construction projects, cash is drawn as it is required, when projects have reached certain milestones in the construction process. Over time, the construction and committed parts of the portfolio suggest that the UK and Australian parts of the portfolio in particular are likely to become a larger part.

Fig.2: Geography / And Or Largest Investments



Source: GSEO, at at 30/06/2023

The team aim to invest in infrastructure assets that are crucial parts of the energy transition, but in areas that have attracted less institutional capital, either because they are too small to catch the attention of large institutional investors, or perhaps operate in a less obvious niche, and so create more potential for both added value from active management and from acquisition pricing. A good example of the team's creative thinking is the investment into gas turbine assets in the UK, which is at the construction phase and expected to be commissioned in 2024. Gas turbines provide flexible power, which is still needed by the grid. As many readers will know, the principal sources of renewable energy, wind and solar, are intermittent, and other technologies are required to smooth this intermittency. While energy storage is an important part of this, pragmatically the grid still needs power that can be switched on and off at will and gas turbines do this job very effectively. GSEO's assets will also capture the Co2 emissions and to create a further revenue stream these will be sold to the food and beverage industry. This reduces the emissions of the assets themselves, but may also displace the otherwise very energy intensive process of producing carbon dioxide used by the food and beverage industry, and so create a further measurable impact on reducing carbon emissions. In terms of future proofing, VH believe that in the future their gas turbine assets may also over time start to burn biofuels and eventually could be converted to burning pure hydrogen if this nascent industry ramps up production of green hydrogen.

Another very good illustration of how the team have identified attractive parts of the transition chain for the portfolio is their first investment, a US fuel storage terminal, which is fully operational. The team note that this terminal is used to store petroleum products of very low quality (high sulphur content) on its way from Mexico to be reprocessed in the US before it is returned to Mexico. This is because Mexico's domestic refinery facilities are not yet capable of removing such things as sulphur, and Mexico has identified public health as a key part of its net zero policy, with high levels of pollution causing respiratory illness. While Mexico has plans of upgrading its own refinery capabilities, this is a complex, time consuming and expensive process, and it will remain the case for many years that it is economic to send fuel to the US for reprocessing, where Mexican oil company Pemex owns refineries. GSEO is not involved in this process, it simply provides the necessary storage facility that connects fuel shipped from Mexico, before it is transferred to rail to be reprocessed, before making the return journey. Since acquisition in 2021, the capacity of the terminal has been upgraded and there is further space to add additional capacity, which the team may be able to exploit in future. As noted in the **Gearing section**, GSEO has very low overall gearing, and this asset is the single asset with debt secured against it.

The team have also entered the fragmented solar market in Australia. They describe Australia's transition strategy as disorderly. With very reliable and high irradiation levels, Australia has huge potential in particular for solar development, but the team note that the transition is not being managed well, with baseload coal power stations, which form the backbone of Australia's energy mix, being shut down without proper planning. As a result, on a local level there is demand for smaller solar assets co-located with energy storage systems. These types of assets, which are below the radar for larger utilities and therefore less subject to competition, can provide private wire power solutions for commercial customers keen to secure a predictable power supply, while the energy storage aspect of the assets can also seek to trade intra-day power price volatility.

GSEO's Brazilian hydropower assets is, like the US terminal assets, fully operational. The asset was acquired from a large utility and essentially the asset was a bit too small for the previous owner to give it the attention it deserved, and so the team would say that the asset has been previously maintained but not actively managed. As a result, there are a number of operational improvements the team have made since the purchase in 2022, as well as negotiating better terms for power purchase agreements. Hydropower is a very well-established and reliable technology, with very long asset lives, and while there is no current intention to do so, these assets would very likely be able to be geared on attractive terms.

Overall, this is a concentrated portfolio, with assets that are very different to more mainstream renewable energy infrastructure trusts, with the potential for the portfolio concentration to decrease as construction assets become operational and potentially achieve valuation uplifts, as well as increasing dividend cover further.

Gearing

GSEO has not deployed any gearing directly. So far, the only gearing is indirect and represents only a modest amount of gearing, c. 14%, secured on its US storage terminal asset. This means that on a look through basis, GSEO is c. 2% net geared once cash on the balance sheet is accounted for. Alternative asset trusts very often deploy gearing at an asset-specific level, with each asset held within its own corporate structure, which allows appropriate gearing for that asset. This is what GSEO has done with its US storage asset, which is fully operational and highly cash generative. All other assets are ungeared.

GSEO's commitments to construction projects are all fully funded by cash held by the trust, and the net cash figure quoted above is calculated after these commitments are deducted. Thus GSEO would not need to borrow or raise new capital to complete its construction projects. Average gearing for the AIC renewables infrastructure peer group isn't straightforward to calculate on a like-for-like basis as gearing may exist at an asset and a top company level, but GSEO is at the bottom end of the range for gearing in the peer group.

A slowly unfolding issue for investors in real assets trusts is that many are geared, and at some point will have to renew debt facilities at potentially much higher interest rates, or realise assets and pay down debt. This will put pressure on things such as dividend cover. GSEO's very low gearing means that it is not exposed to any refinancing events and its dividend cover is based on very lowly geared cashflows. As we discuss in the **Discount section**, this also gives it more flexibility to buy shares back in response to its wide discount. In time, GSEO also has the option to introduce more gearing, which can be assessed on merit, rather than simply because it needs to renew a debt facility. Thus by entering a higher interest rate environment without any significant gearing, the team have left a number of options on the table.

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

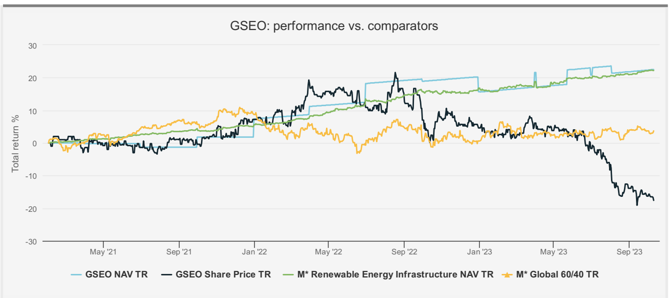
- First, that limited recourse debt, i.e. the type of debt discussed above that it applied to individual assets, is in aggregate limited to 60% LTV
- Second, that any debt at the top company level, which would be shorter term debt used, for example, to help fund acquisitions, is limited to 30% LTV.

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

Performance

GSEO was launched in February 2021 and the chart below plots its NAV and share price performance since then against a couple of comparators: the AIC renewable energy infrastructure peer group and the Morningstar Global 60/40 Index. As we have argued recently , trusts such as GSEO should really be thought of sitting somewhere between bonds and equities, rather than as the "alternative income" or "bond proxies" that they tended to be labelled as during the zero-interest rate era. On the one hand there are long-term contracted cashflows, but on the other hand there is some operational exposure, for example to fluctuating power prices, and this gives more of an equity flavour. Thus we think looking at a "60/40" equity / bond index is a helpful comparison even if we don't imply it is a precise benchmark. As we discuss in **Discount**, discounts across the investment trust sector have widened, and especially so in relation to alternative asset classes such as this.

Fig.3: NAV And Share Price Total Return Since Launch

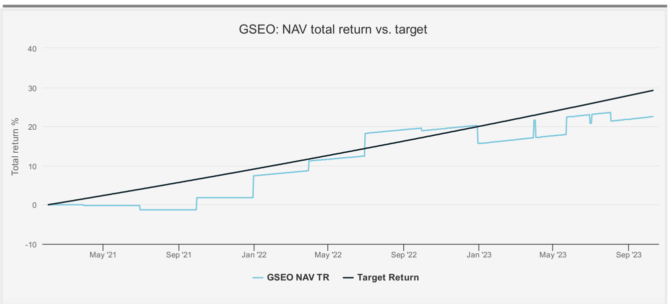


Source: Morningstar, as at 10/10/2023
Past performance is not a reliable indicator of future results.

GSEO targets a 10% NAV total return once fully invested, and while the period since its launch in February 2021 is relatively short, and it has not been fully invested through this period, below we show the NAV total return against the 10% target. While this is a target not a benchmark, it does serve as a relevant performance indicator. Noting the short period since launch, and the fact that GSEO has a number of assets at construction phase, GSEO has the potential to exceed the target without the need to raise further capital as these assets become operational, and if valuations get written up.

In the near term it is likely that the most significant driver of performance will be the construction projects. Projects brought through the construction process will potentially see significant uplifts in value as they move from a cost basis to a valuation based on operations. Although other renewable infrastructure trusts are increasingly taking on some construction risk, GSEO is more firmly targeting returns from construction. Typically one would expect returns from construction projects to be in excess of GSEO's target return, if they are successful. There can be no guarantees though.

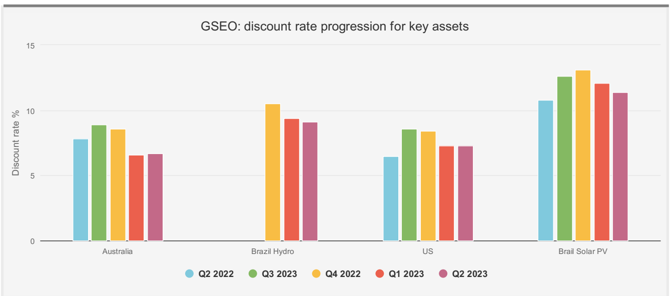
Fig.4: NAV Total Return Against Return Target



Source: Morningstar, as at 10/10/2023
Past performance is not a reliable indicator of future results.

The chart below shows discount rates for the operational assets in the portfolio. This illustrates that GSEO's valuations are dynamic from quarter to quarter, and that discount rates have been compressing in 2023 after peaking at the end of 2022. Although risk free rates have increased in 2023, this has been offset by equity and country risk premia, as well as industry betas. This is a slightly different picture to the UK, where risk free rates have risen more than any other compensating factors, and there has been a slight rise in discount rates across renewables as a result. Given the very concentrated nature of the current operational portfolio, the breakdown below of discount rates for the four operational assets is, in our view, more useful than a blended average. It is worth noting that the three largest assets, the Brazilian hydro, the US terminal and the Australian solar all have discount rates of less than 10%, which is a reflection of a base case scenario, and as discussed in the **Portfolio section**, the team acquire assets where they believe that there are additional returns to be generated from asset management.

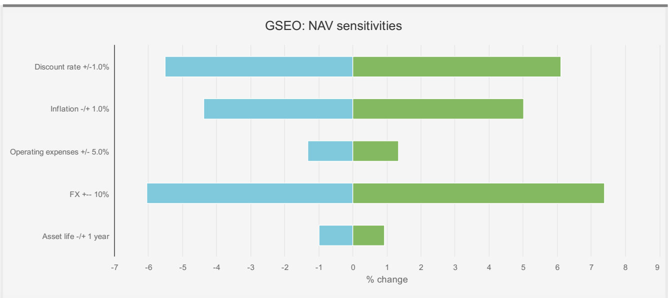
Fig.5: Unlevered Discount Rates



Source:GSEO

The chart below shows GSEO's main NAV sensitivities illustrated in a fairly standard format for renewable energy infrastructure trusts. These sensitivities don't, however, take into account the construction assets, which as we discuss above, if they are successful are the most likely source of returns in excess of the performance target (or source of risk that returns fall below target). The main difference with the peer group is GSEO's much greater sensitivity to changes in currency exchange rates, which is simply a function of its global mandate. The team do not hedge currency for the purposes of the NAV and so the NAV will fluctuate with exchange rates. They do, however, employ hedging in the short term against expected income each year, which largely eliminates changes to exchange rates as a risk to each year's target dividend. The chart also illustrates GSEO's strong inflation-linkage, although of course this can't be directly compared to a UK-only renewables trusts, as the inflation rates used to calculate GSEO's overall inflation sensitivity come from the US, Brazil and Australia.

Fig.6: NAV Sensitivity



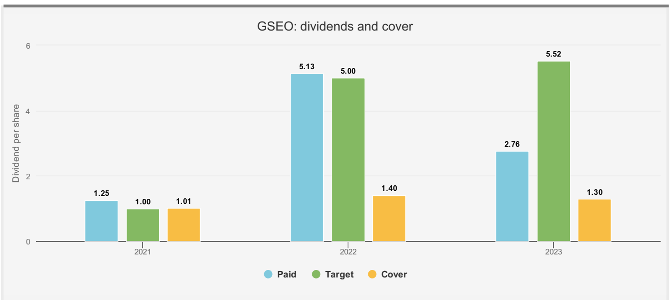
Source: GSEO, as at 30/06/2023

Dividend

GSEO pays dividends quarterly and has a progressive dividend policy, aiming to increase the dividend each year. The chart below shows a familiar pattern of dividends in the first three years of a new fund launch, with the first year, where capital is being invested, seeing a small dividend before reaching the target level in the second year. GSEO gives guidance each year on the target dividend, and in both 2021, the year of launch, and 2022, the actual dividend paid slightly exceeded the target. The chart below shows both the target given at the start of the year and the actual dividend paid, as well as the dividend cover. For the financial year ending 31 December 2023, GSEO has set a target dividend of 5.52p, a 7.6% increase on the previous year. At the half year stage the trust paid 2.76p and the board reported that dividend cover at that stage was 1.3x and reasserted the full year dividend target. GSEO's share price yield on a prospective basis is currently 7.1% (based on the dividend target).

The team estimate that dividend cover will increase to 1.6x to 1.8x when all construction assets are operational, which if achieved would allow the board the latitude to significantly increase the dividend, or provide further firepower for share buybacks.

Fig.7: Dividends And Cover



Source: GSEO, as at 30/06/2023

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.

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 close to 24 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. Focusing 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 focused 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.

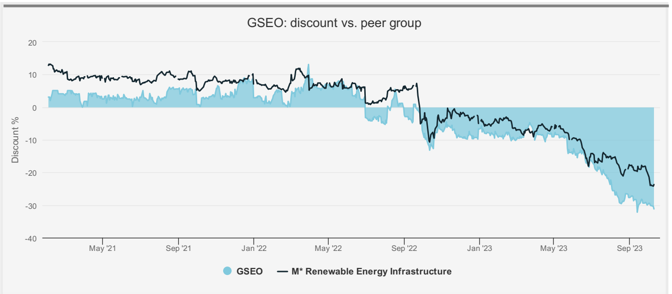
Richard and Eduardo lead a team of 19 professionals, covering areas such as legal, finance, operations, risk, compliance and investor relations. Currently GSEO is the team's sole focus.

Discount

GSEO trades on a 26.6% discount at the time of writing, compared to an average discount of c.24% for the AIC renewable energy infrastructure peer group. The chart below plots a now-familiar pattern, with GSEO and its peer group's discount widening in response to rising interest rates. In our view, GSEO's discount is mainly explained by macro factors, but its wider discount is also likely to be a consequence of its higher risk profile compared to the peer group, given as we discuss in the Portfolio section, GSEO has exposure to construction stage assets.

As we discuss in the **Performance section**, we view GSEO and its peers as having some characteristics of bonds and some of equities, and so while the main catalyst for a narrowing of the discount is likely to be a change in the direction of interest rates, the passing of time is likely to reinforce the potential for GSEO to generate real returns, in contrast to bonds. A new-found appreciation by investors for this characteristic may also be a catalyst for the discount to narrow. In addition, the assets under construction could lead to uplifts in both NAV and the dividend, which could both contribute to further positive sentiment, and a narrowing of the discount in time.

Fig.8: Discount Since Inception



Source: Morningstar , as at 10/10/2023

GSEO has a discount policy that states that "If, in any 3-month rolling period, the ordinary shares have, on average, traded at a discount in excess of 5 per cent to the NAV per ordinary share, the Fund intends to use 50% of net cashflows to repurchase ordinary shares." At time of writing, that condition has been met and in September 2023, GSEO's board announced a share buyback programme for up to £10m worth of shares, as a response to the c.30% discount, which exceeds the formal requirement noted above.

We discuss in the **Gearing section** how GSEO has deployed very little gearing, and in our view this makes the decision to buy shares back less complicated than it may be for other alternative asset funds, as the buyback can be funded from cash on GSEO's balance sheet. In our view, the impact of share buybacks on the discount can vary from situation to situation, but what is certain is that buying shares back at a 30% discount increases the NAV for remaining shareholders and is, in effect, making an investment in a portfolio of known assets at a price much lower than they would otherwise be available at. In GSEO's case, because it is not selling any assets to fund the share buyback, it will also have a positive impact on dividend cover, since the portfolio will continue to generate the same amount of income, but there will be fewer shares to pay out a dividend on. As we note in the **Portfolio section**, commitments to fund construction are fully funded separately to the cash allocated for share buybacks.

In common with many real asset funds, GSEO has a periodic continuation vote, held every five years, with the first one due at the AGM in 2026. While shareholders do, from time to time, vote against continuation, this is usually in extreme circumstances, and more often than not continuation votes are a chance for the trust's board to consult with shareholders before the vote is held. As such we view continuation votes as a standard backstop protection for shareholders.

Charges

GSEO has an OCF of 1.3%, 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's investment management fee is 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 time of writing, with net assets of c. £465m, GSEO's blended management fee is c. 0.95%.

There are some additional features of the investment manager fee,

- 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, both these conditions were met and 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.

GSEO is, in contrast to an investor in listed equities, an asset owner, and therefore the team are able to directly influence each asset's approach to sustainability. 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. Nevertheless some ESG screens may still show GSEO as having some 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, as defined by **FTSE Russell's Green Revenues Classification System**.

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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