REDWOOD GROVE CAPITAL

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Public Equity Climate Strategies

A not uncommon question about incorporating climate science into public equity investing is: does it really matter? Public companies outside of oil and gas companies are too big and diverse, the argument goes, to have a real impact. Our friends at Generation Investment Management put out a report this month concluding that 38-40% of all annual global emissions come from publicly listed companies.[1] After reading the report, we believe it is clear they intentionally erred toward a conservative analysis. They include Scope 1 and 2 emissions, exclude certain Scope 3 emissions and rely largely on unaudited reporting which has historically understated actual emissions.[2]

How these companies transition to a low carbon economy is going to be critical in two ways. First it will determine the speed at which economies transition from fossil fuels. Government regulation is beholden to business, at least in the United States, and without corporate support it will not happen at a quick enough pace. Second, Redwood Grove believes that how companies manage that transition is going to be the most significant determinant of which industries and companies thrive in a new economy. As investors that means it has the potential to be not just an alpha generator but the most important one. Chris Ailman the CIO of CalSTERS put it even more forcefully when he said climate change "is a mega-trend that if you take advantage of it, and get ahead of it, it's going to be an alpha generator for the next 30 or 40 years."[3]

Institutional investors in the public equity market often find themselves with two suboptimal choices, either invest in a pure play climate strategy where valuations are very high or invest in a diversified mutual fund where the investments are based on Environmental, Social and Governance ("ESG") data of very questionable accuracy. Redwood Grove's prior letters have discussed the challenges of ESG data, and the investment space built around it. If you are interested in hearing more about it, you can listen to our partner Ted Roosevelt's recent podcast on Experts Only (here). Clean tech ETFs are attracting more capital than ever before. According to Bloomberg, the largest clean tech ETF Blackrock's iShares Global Clean Energy fund is down 23% this year yet still attracted $2.8 billion of new investor funds.[4] The Blackrock ETF originally tracked 30 clean tech companies. These companies are generally mid to large market cap companies. With significant fund inflows chasing a limited number of investments, share prices are being driven up

[1] https://www.generationim.com/our-thinking/insights/listed-company-emissions/
[2] https://www.aljazeera.com/economy/2021/4/6/bbaramcos-new-disclosures-still-understate-its-carbon-footprint
[3] https://etfdb.com/big-ideas-channel/can-climate-change-be-a-long-term-alpha-generator/
[4] https://www.bloomberg.com/news/articles/2021-10-11/clean-energy-stocks-are-being-diluted-by-huge-cash-inflows-green-insight

regardless of valuation measures. Recognizing this challenge, Blackrock (and others) expanded the number of underlying names in their ETFs, often, to less "pure" play names. The iShares Global Clean Energy Fund expanded its holdings to 80 names this April to accommodate these cash flows. They have suggested they may expand it to 100 names by the end of the year. Even with the expanded portfolios, fund flows are creating a strong technical updraft for pure play climate names.

As fundamental value investors, clean tech's high valuations can present a challenge. However, Redwood Grove continues to find opportunities in unlikely places. Finding attractively valued companies that will help mitigate the impacts of climate change means evaluating second order impacts. Renewable energy supply has grown at a 16.5% CAGR over the last decade and is forecast to increase at a low double digit CAGR through 2030[5]. Redwood Grove looks at the impact that the growth in renewables will have, not just on solar and wind developers but also on data storage demand and the need for increased interconnectivity. Which is why, in addition to investments in renewable companies, Redwood Grove has investments in the data storage company Western Digital and the 5G patent leader (the backbone for IoT), Qualcomm. Redwood Grove also looks at what the increase in renewable electricity supply and energy efficiency will have on public utilities. Distributed energy sources, intermittent generation, and grid stability will all change how utilities are run over the next decade.

Willdan

A company not commonly found in clean tech ETFs is Willdan, an energy consulting firm that works with public utilities, private companies, and public agencies. Willdan has two main business segments: energy services and consulting. The energy services segment which accounts for 80 percent of their revenue focuses on energy efficiency, working with clients to help them optimize energy spend. The majority of Willdan's business comes from New York and California, though they have customers in the Midwest, Southwest and Mountain states. Both New York and California have programs supported by public agencies to help drive increased energy efficiency. The American Council for Energy Efficient Economy ranks the two states in the top five nationally for their public programs to promote energy efficiency.[6]

In California, utilities are required to spend a percentage of their allowable rates on creating new energy efficiencies. The California Public Utility Commission ("CPUC") discovered that the public utilities were charging the increased rate but were not implementing any substantive energy efficiency programs. As a result, the state legislature mandated that 60% of the $1 billion dollars of annual energy efficiency programs must be outsourced to third party providers by 2022 and 100% by 2025. This was a big tailwind for Willdan which won more than $700 million of new contracts in California alone, more than its prior market share in the recent round of outsourcing. In addition, the CPUC recently expanded the definition of energy efficiency beyond simply the "optimized energy and peak demand" savings to include benefits of greenhouse gas reduction. This expanded the number and scope of available projects for companies like Willdan.

[5] https://www.wsj.com/articles/renewable-energy-us-power-11626098450
[6] https://www.aceee.org/sites/default/files/pdfs/u2011.pdf

California is not alone in its efforts to improve energy efficiency, because the cleanest source of energy is always the one we do not use. All but two states in the United States have some sort of energy savings program, and the trend over the past decade has been to add to their scope. These programs have a meaningful impact. Energy savings from ratepayer funded energy efficiency programs like the ones Willdan implements were 26.9 million mega-watt hours in 2020 or 0.7% of total retail sales in the United States. That's enough to power 2.6 million homes for a year. This cost-efficient way to reduce greenhouse gas emissions is growing in popularity. Each year states create or improve energy efficiency standards. In 2019, five states adopted 100% clean energy targets, in 2020 they were joined by Virginia. The Virginia bill requires their largest utilities Dominion and Appalachian Power to achieve electric savings equivalent to 5% and 2% of sales, respectively. This and other state legislation provide an expanding market for energy consultants. Willdan's leadership in states that were early adopters of efficiency policies benefits from these expanding regulatory changes.

Willdan can also expect a stabilization of their revenue. They typically have 3-to-5-year contracts with utilities and public agencies to implement energy efficiency programs. Utilities are traditionally stable counterparties. Despite this stable customer base in utilities, Willdan was unable to access many of the facilities necessary to do energy efficiency work during the pandemic. One of their largest contracts is with LA Department of Water and Power which did not re-open access to efficiency projects until June of 2021. Now that all contracts have restarted, we expect revenue to stabilize and then grow at double digit rates. The company is currently trading at 17.8x 2022 earnings, a discount to the market, despite its attractive growth prospects and stable sources of revenue. This combination of stability and long-term growth make Willdan an attractive investment for Redwood Grove.

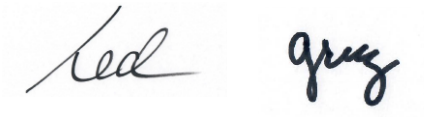
Closing Thoughts

Finding opportunities in the era of climate change means looking at the full range of its economic impacts. Another area Redwood Grove has spent time researching is the impact of climate change on human health. While this area of focus is rare for investment managers, it is a focus for health organizations. The World Health Organization (WHO) published an 84-page report, during a global pandemic no less, that concluded that "climate change is the single biggest health threat facing humanity."[7] In it the WHO mentions nine climate sensitive health risks will accelerate over the coming decades. Many of them Redwood Grove has researched in our analysis of physical impacts of climate change. We have incorporated our findings into our search for companies that are helping us adapt to a warming planet. The WHO report identifies three climate sensitive health risks expected to increase that can be found in Redwood Grove's investment analysis: respiratory illness, zoonoses and vector borne diseases. In line with the WHO report, Redwood Grove also believes that "in the short- to medium-term, the health impacts of climate change will be determined mainly by… the extent and pace of adaptation." In other words, one would far prefer to avoid the bad health outcome but given the short- and medium-term intractability of climate change the best solution is developing vaccines and products to help us adapt.

[7] https://www.who.int/publications/i/item/cop26-special-report

As always, thank you for your continued trust in us. If you have questions, concerns or comments please do not hesitate to reach out.

With gratitude,



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