REDWOOD GROVE CAPITAL

July 19th, 2023

Earth's Hottest Day

July 4th 2023 was likely the hottest day on Earth in the last 125,000 years.[1] It was part of the hottest week on record according to the World Meteorological Organization.[2] Both came on the footsteps of our planet's hottest June on record which was 1.5 degrees Celsius hotter than pre-industrial averages. A dubious set of records. To put this in geological time, all human civilization is about 12,000 years old. Not once since humans stopped being nomadic have we experienced this range of temperatures. The high temperatures are driven by two things, human-caused climate change and the start of El Nino. Both were forecasted by the scientific community.

The increased *average* heat creates more extreme tail events. In June extreme tail events were seen across the American South. Texas had two weeks of record high temperatures reaching almost 120 degrees. The heat did not break in the evening. It is a trait of climate change that nighttime average temperatures increases more than the daytime averages. This 24-hour heat cycle puts increased pressure on the human body and causes more deaths and heat-related illnesses. It also puts more pressure on the electrical grid because the transformers cannot cool down overnight. Ed Hirs, an energy economist at the University of Houston describes the situation as "the ERCOT[3] weather roulette wheel. On that roulette wheel, the wedge for blackouts keeps getting larger."[4]

In Redwood Grove's 2022 third quarter letter, we discussed the increased pressures that electrical grids were facing across the country. Years of under-investment and increased stress due to higher demand and more extreme weather have led to a rise in power outages. In the last decade alone blackout hours in this country have doubled. Despite this trend, our review of Wall Street research found that analysts often revert to the long-term historical average when estimating future blackouts. This is not entirely surprising; equity analysts are trained to use historic data to forecast the future. While analysts are also good at identifying consistent quarter over quarter trendlines, to see the growth in blackouts and the physical impacts of climate change one needs to pull back one's field of vision ever so slightly; just beyond the horizon of most Wall Street equity analysts.

Climate change's impacts do not increase linearly, however, 2023 is slightly different in that regard because of the El Nino and La Nina effects. El Nino causes an increase in Pacific Ocean surface temperatures and La Nina causes a cooling. The current hottest year on record was 2016 an El Nino year. The past three years have been La Nina years, dampening some of the impacts of human-caused warming. 2023 marks the start of a new El Nino cycle. Scientists anticipate that this year's return of El

[1] https://www.washingtonpost.com/climate-environment/2023/07/05/hottest-day-ever-recorded/
[2] https://public.wmo.int/en/media/news/preliminary-data-shows-hottest-week-record-unprecedented-sea-surface-temperatures-and
[3] Electric Reliability Council of Texas
[4] https://www.eenews.net/articles/soaring-temperatures-test-electric-grid-in-transition/

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Nino will lead to new record high global temperatures.[5] The recent spate of record highs indicates the forecast will likely be accurate.

Generac is a home standby generator and clean tech company. In late 2021 and early 2022 the stock fell from 36x price to earnings to 12x's price to earnings. The decline was in part due to some challenges in their clean tech business, but largely the result of a decline in generator demand due to an atypically low number of power outages in the United States. Wall Street Analysts started to look at 2021 and 2020, years when the United States had seen significant power outages driving home generator sales as anomalies. While 2022 was a down year for power outages, there is a lot of evidence and scientific forecasts that over the long-term power outages would continue to grow in the United States. Home generators would increasingly go from a luxury item to a necessity. Importantly the last three years had the cooling effect of La Nina, and that would change. In the third quarter of 2022 we initiated a position in Generac.

2023 is shaping up to be as forecast by climate scientists if not Wall Street. Currently the United States is experiencing a heat wave from California to Florida, impacting 115 million people.[6] The "tails" or extremes are setting new records across the country. Death Valley is forecast to set the new record temperature on the planet.[7] Texas has been experiencing a heat wave since late June. The heat wave led to record demand on ERCOT the Texas grid.[8] Concerned customers started inquiring about generators. At the end of June, Generac's CEO announced that they have seen "a dramatic increase in the Texas Region in sales leads for our generator and battery backup systems." Generac's stock was up almost 40% in the quarter. We believe at current levels it remains a compelling investment.

This high heat is only one example of where we will see demand curves bending upwards. In Florida this month, ocean buoys are measuring water temperatures in the high 90s degrees Fahrenheit[9] with the historically hottest month yet to come. To put that into context a hot tub is typically warmed to 100 degrees. Something discussed in more detail in our last letter, increased ocean temperatures directly correlate to more powerful hurricanes and tropical storms. We anticipate that PGT Innovations (PGTI), an impact-resistant window company based predominately in Florida, is likely to see increased demand for their windows both from repairs and continued changes in the building code.

While Redwood Grove incorporates climate adaptive trends into our investment analysis, the majority of our portfolio is invested in mitigative strategies. Both PGT Innovations and Generac are also mitigating the impacts of climate change. PGT Innovations' double- and triple-pane windows significantly improve the energy efficiency of a home. Upwards of 25% of a home's total energy use can

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[5] https://public.wmo.int/en/media/news/preliminary-data-shows-hottest-week-record-unprecedented-sea-surface-temperatures-and
[6] https://www.axios.com/2023/07/14/heat-wave-worsens-shattering-records
[7] https://www.scientificamerican.com/article/death-valley-could-set-a-world-record-hot-temperature/
[8] https://apnews.com/article/texas-heat-wave-2023-power-grid-758daa1be9d472f85028ab12bdc263ca
[9] https://www.cbsnews.com/news/florida-ocean-temperatures-rise-to-the-90s-nearly-hitting-100/

be lost through the windows. PGT Innovation windows can reduce that by 95%. Generac is investing significantly in home battery technology, EV chargers, smart thermostats, and solar inverters. The company is building a connected renewable home energy ecosystem. Connected Generac homes become a distributed energy source that can feed energy back to the grid, improving grid resiliency. This strategy to build off their home generator dominance increases Generac's addressable market five times.[10]

This quarter our largest new holding was the mitigator NextEra Partners a yieldco that is one of the largest owner-operator of clean energy projects in the world.[11] Yieldcos are financing vehicles for clean energy development companies. Some of Redwood Grove's most successful investments have been in yieldcos, equity instruments that function like fixed income. We have not recently invested in this sector as yieldcos, like fixed income securities, are hurt in a rising rate environment. They are a collection of renewable and other energy projects that have long-term off-take agreements and typically offer a steady dividend stream to investors. That dividend grows as more completed projects are sold from a project developer to the yieldco. Over the past decade, NextEra Partners has been the pre-eminent yieldco, growing the fastest with the largest pipeline of potential new deals. As a result, it has traded at a premium to its peer group.

Yieldcos offer equity investors a source of relatively secure income in the form of a growing dividend. NextEra has historically had the lowest dividend payout relative to its peers because its dividend has grown the fastest. NextEra's projected and historical dividend per share growth rate is 12-15%. The average growth rate for NextEra's peer group is 4.5-7.5%. Because yieldcos use leverage to buy new clean energy projects, if the cost of borrowing goes up without a corresponding increase in project yields, the growth rate of the yieldco will slow. NextEra confirmed this fact on their last quarterly call, saying growth rates would be in the lower end of the range going forward.

Following the quarterly call NextEra's stock dropped raising the forward dividend yield to above 6%. This is 50% greater than its 10-year average, and at a discount to its peer group. The opportunity to buy the fastest growing yieldco at a discount to peers is compelling. The company also announced that they will initiate the sale of their mid-stream natural gas pipelines as they pivot the portfolio to 100% renewable energy. A goal they plan to reach by 2025. The sale of these assets will reduce the cash available for distribution which is what is used to pay the dividend. This was concerning to the market, but NextEra Partners' parent company has suspended any cash distributions up, instead using that capital to maintain the dividend until the proceeds from the sale can be redeployed. This helps reduce the yieldco's cost of capital, which is important for the parent company.

[10] https://investors.generac.com/static-files/c856a3a2-65ff-48ed-8a6d-81eb45214f82
[11] https://www.prnewswire.com/news-releases/nextera-energy-partners-lp-announces-plan-to-become-the-leading-100-renewables-pure-play-investment-opportunity-301818097.html

NextEra Partner’s discount to its historical average and its peer group attracted our attention. In addition, the passage of the IRA with its $127 billion dollars of renewable energy tax credits should help accelerate growth for NextEra Partners. Finally, if there were a decline in long-term interest rates it should be beneficial to yieldco valuations.

Closing Thoughts

I (Ted) grew up catching frogs in my grandparents’ backyard. I would crawl on my stomach to the edge of their pond, peer over the ledge and then position myself so I could snatch the nearest bullfrog. Most of the time I failed miserably, but occasionally I’d catch one. It always made my day. My parents have pictures of me, covered in mud, in my underwear holding a frog or even two if the hunt had been a success with a huge grin on my face. Over forty years later, I remember those times well.

Unfortunately, amphibians are at particular risk to climate change with over 50% of the species at risk of extinction. The first to go extinct due to climate change was the Golden Toad. Climate change mostly because of its speed is causing a mass extinction event. There is hope. I was recently able to interview Christiana Figures, the executive secretary of the UN Framework Convention on Climate Change that ushered in the 2015 Paris Accords. It was arguably the most impactful global agreement to fight climate change to date. She told me that it was the extinction of the Golden Toad in her home country of Costa Rica that inspired her to dedicate her life to fighting climate change. While things are getting worse right now, each extinction, each record temperature, each felt impact of climate change has the potential to inspire people to make a change. Some small, some large. Each in their own way. We remain optimistic that the fight has just begun, and more and more people are joining.

Our goal remains to identify climate risks and opportunities that will help Redwood Grove outperform. For the planet’s sake, we hope the market follows. Thank you for your continued trust in us.

With gratitude,

Ted   Greg

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