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Talking Point



Renewable energy: short-term headwind

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Matt Franklin is a Global Climate Change portfolio manager and a Global Sector Specialist on our Global and International Equities team. Matt covers the industrial and material sectors and is responsible for identifying the best investment ideas in his sectors on a global basis.

Here, Matt discusses the global wind industry, on which he has become more cautious on the near-term prospects.

For some time now, our Global and International Equities team has been negative on the current investment case for most renewable energy investments, especially solar, due to stretched valuations and exuberant growth expectations, but positive on wind as the most economical renewable energy source. The credit crunch, however, has reduced funding availability and increased costs, while lower commodity and power prices have further reduced Internal Rates of Return (IRR). This is resulting in a probable 10-30% decline in wind installations in 2009, as some projects are either delayed or cancelled.

In short, the credit crunch will alter the next 12 months operating environment for the wind industry at a time when a fairly large amount of new capacity comes on-stream. This is a temporary downturn, in our opinion, but a significant one nonetheless, and although some of the stocks in the wind industry have already declined 60-70% in the last few weeks, the earnings and cash flow impacts are going to hurt the supply chain further. Against such strong headwinds, we have reduced our exposure.

20-30% growth could blow just as strongly the other way in 2009

Wind farms are typically funded with up to 80% debt finance, which has increased in cost, and reduced in availability following the failure of Lehman Brothers in September. Both the number of willing bank lenders and the amount that they are currently willing to lend to individual projects has declined.

This has been reflected in cuts of approximately 30% to existing 2009 investment plans from leading wind farm developers FPL and Iberdrola Renovables, with some smaller developers even further impacted. It seems to us that the larger utility companies, especially, can generally get credit, but that the higher cost of debt and lower leverage levels are reducing the IRR on most projects, and the less attractive ones are being delayed. In short, unless the debt markets improve in the next few months, 2009 will be a much weaker year than the industry was expecting.



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The American Wind Energy Association recently forecast that US installations in 2009 would fall by 33% on the back of lower availability of tax equity financing. The US, along with China, was expected to represent 40-50% of new installations from 2007 to 2012 and was a particularly important market for European wind turbine manufacturers given slowing growth in such countries as Spain.

Backlogs of up to three years in some cases would suggest growth in 2009 is locked-in, but with limited pre-payments, it is hard to know how much is firm and some cancellations are almost certain.

Slowing demand and expanding production capacity (not a good mix)

Markets have been incredibly tight for the last few years and the turbine manufacturers have had excellent pricing power, which has facilitated gross margin expansion and expectations of all-time high industry margins in 2009-10. As the market shifts aggressively to one of excess supply, pricing is likely to come under pressure and capacity utilisation levels are likely to collapse leading to huge pressure on EBIT margins. It is worth highlighting that this was an industry that was losing money less than five years ago.

Working capital moves will exacerbate the earnings down cycle

Working capital used to be a problem in this industry, as the turbine manufacturers had to fund a typically small customer base and given unpredictable order flow. In the last few years though, working capital to sales ratios having fallen dramatically, as large pre-payments have become standard practice, and allowed some companies to finance all their working capital needs with customer pre-payments. This will almost certainly reverse, given the excess supply in the industry, and lead to significant working capital outflows, which will cause a significant increase in the interest costs.

Long-term outlook strengthened, but we are cautious in near term

So, we are left with a complex outlook for renewable energy stocks. Recent legislation has actually strengthened the long-term growth outlook for renewable energy technologies – and Barack Obama favours a 25% renewable energy requirement by 2025, which will give it a huge boost – yet the near term is clouded by credit market uncertainty. With valuations significantly lower now, the sector is being set up for a very good long-term buying opportunity in the next nine months. For the time being, we remain cautious on wind.

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