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The Stocktake Series

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Vestas – A renewable investment opportunity

Wind and solar power have a major role to play across the global economy in the drive to net zero, with figures from the International Energy Agency (IEA)[1] suggesting onshore wind capacity will grow by up to 70% in 2023, rebounding from two years of decline during the Covid pandemic.

Better resource efficiency is a key investment theme for the Sustainable Investment team. Within our key themes we look at companies that exemplify different sub themes – in this case, increasing electricity generation from renewable sources.

Structural growth from sustainable investment themes

To decarbonise our economy we need to replace fossil fuels, with a likely substantial shift towards electrification. This will be especially pronounced in personal travel (using electric vehicles instead of internal combustion engines) as well as in heating (and cooling) buildings by using heat pumps instead of natural gas and oil boilers. For this decarbonisation through electrification to work we need the electricity on the grid to be low carbon.

The disruption from renewables (wind and solar) displacing fossil fuels in electricity generation is well under way and we anticipate it to accelerate over the next decade and beyond. As these renewables have increased in volume, there have been significant reductions in costs. In the case of wind, unsubsidised costs have fallen by over 60% since 2009, making onshore wind the cost-effective form of new electricity generation on the planet.[2] Offshore wind is also more economic and takes less time to build than new nuclear. There are regulatory drivers to decarbonise and we anticipate that global regulations to decarbonise our economy will tighten globally over the next decade.

Vestas – Driving the wind revolution forward

When it comes to companies taking a key role in this area, we believe Danish wind turbine manufacturer and service provider Vestas Wind Systems (Vestas) stands out.

Wind power is a renewable and low carbon source of energy and the company contributes to reducing emissions from the electricity grid by providing cost competitive wind-derived electricity. It is one of the three main players outside of China in this sector.

Vestas estimates that over the life of the turbines it installed in 2022 around 408 million tonnes of CO2 (cardon dioxide equivalent – a measure of greenhouse gas emissions) emissions will be avoided. In comparison, the sum of emissions from the company in 2022 (including scope 1 direct emissions, scope 2 indirect emissions and

[1] Renewable Energy Market Update - June 2023 – Analysis - IEA

[2] Lazards Levelised Cost Of Energy 2023 (p.2). www.lazard.com/research-insights/2023-levelized-cost-of-energyplus/ accessed 19-Sep-2023

scope 3 supply chain emissions) was 8.3m tCO2e.[3] This means in 2022 the emissions from making their turbines was nearly 50 times less than the expected avoided emissions over the life of those turbines.

The biggest driver of renewable adoption now is economics: that it is so cheap. We see structural growth in demand for wind turbines and their maintenance over the next decade and beyond. While this will vary for individual companies depending on the countries they operate in, we conservatively expect wind demand to grow at more than a 5% compound annual growth rate (CAGR) over the next decade.

Management quality

We think Vestas is the best managed business in its industry. Its western competitor Siemens-Gamesa has suffered from management problems and churn following the merger of Spanish Gamesa and German Siemens, while GE Wind historically did not have the focus from management in the large GE conglomerate. We believe these competitors look to Vestas as the industry leader to beat.

Vestas has been leading the industry in simplifying the manufacturing process and improving supply chains as well as providing efficiencies from increased scale of wind turbines (bigger turbines are more efficient in terms of how much electricity they can generate as compared to smaller ones). As well as innovating in wind turbine manufacture, it has also been innovating in improving the lifecycle of wind turbines to reduce the environmental impacts such as through partnerships to work out how to reuse turbine blades at end of life.

Business fundamentals and profitability

There have been many challenges for turbine manufacturers and wind developers to overcome over the past decade. First, a move away from fixed subsidies to a competitive auction (where the cheapest bid for a wind project won) meant the cost of wind dropped dramatically but so too did the cost of turbines.

In its focus to become the cheapest form of electricity generation, the turbine industry appeared to have little if any pricing power and profit margins went through a period of deep compression in the period from a peak operating profit margin of 14% in 2016 to 3% in 2021. This was further compounded over the past two years following Russia's invasion of Ukraine and the subsequent supply chain bottlenecks which resulted in super-inflation, especially in steel epoxy composites used in blades as well as logistics costs. As a result, the operating profit margin was in -8% 2023.

Wind developers need certainty on costs when they order a wind turbine and agree a fixed cost for a turbine to be manufactured, transported, installed and maintained. Unfortunately for the turbine manufacturers, there is a significant delay between placing of a firm order and delivering the turbine; on average 18-24 months[4]. The past two years have seen all wind turbine manufacturers lose money on wind turbines they have been delivering as they had to absorb the super-inflation and deliver the turbines. The response from the turbine manufacturers is to increase the prices of wind turbines – for the first time in a decade – as the whole industry realised that manufacturers had to make some profit to share the returns in the industry. Vestas has increased average selling prices for its turbines by over a third in the past two years. We expect margins for turbine manufacturers to recover as they work through their unprofitable contracts and the higher prices start to materialise and show up in normalised adjusted operating profit margins of around 5-10% for Vestas in 2025/6.

There have been other issues to contend with such as warranty costs which have been higher than normal (Vestas warranty costs have been elevated at around 6% of sales versus the longer term average of 2-3%). More recently, the profit warning and large provision for warranty issues with blades in new onshore turbines from competitor Siemens Gamesa has raised serious concerns about reliability of some of the newest turbine models in the industry. And finally, (bad news often comes in threes), this same super inflation has affected the economics of

[3] Vestas Sustainability Report 2022, (p.4) www.vestas.com/content/dam/vestas-com/global/en/sustainability/reports-and-ratings/sustainability-reports/Sustainability%20Report%202022.pdf.coredownload.inline.pdf accessed 19-Sep-2023

[4] There are meaningful differences in this lead time depending on geography, with the US typically being less than 12 months and emerging markets often taking twice as long due to logistics and supply chains

newer offshore wind projects with some high-profile offshore projects being mothballed as the numbers don't add up (due to inflation and the high cost of debt). Again, this is related to pricing, with some winning bids for offshore being too low to make an economic return. We expect pricing of new offshore wind projects to rise to reflect this new economic reality while still remaining competitive compared to other forms of new electricity generation.

So far, so…bad? The market is focused on these negative issues and shares in these businesses, including Vestas, have been volatile and sold off hard reflecting these concerns. While these risks are real and need to be managed, we believe the market's focus almost entirely on these concerns is missing the compelling longer-term opportunity when this industry has worked through and solved these issues – which we believe it will and this will be led by Vestas.

Valuation

Our investment thesis is that Vestas delivers improving margins as pricing better reflects its costs over 2024/5. We see compelling earnings growth in excess of 12% CAGR and on 20x forward price-earnings ratio, we see ample upside (above our 10% annualised upside hurdle) on a five-year view.

This is a good example of our investment process leading us to take a patient approach as we monitored business fundamentals and valuation rather than simply rushing into an investment due to its great sustainability drivers. We bought into Vestas in July 2022 using a smaller position size to help reflect and manage the stock's higher volatility. We believe that being patient will reward investors in this business over the medium term as Vestas delivers on its strategy and decarbonises our electricity system in the process.

Mike Appleby, Fund Manager, Sustainable Investment team

For a comprehensive list of common financial words and terms, see our glossary at:
https://www.liontrust.co.uk/benefits-of-investing/guide-financial-words-terms

Key Risks

Past performance does not predict future returns. You may get back less than you originally invested. We recommend this fund is held long term (minimum period of 5 years). We recommend that you hold this fund as part of a diversified portfolio of investments.

The Funds managed by the Sustainable Future Team:

Are expected to conform to our social and environmental criteria.

May hold overseas investments that may carry a higher currency risk. They are valued by reference to their local currency which may move up or down when compared to the currency of a Fund.

May hold Bonds. Bonds are affected by changes in interest rates and their value and the income they generate can rise or fall as a result; The creditworthiness of a bond issuer may also affect that bond's value. Bonds that produce a higher level of income usually also carry greater risk as such bond issuers may have difficulty in paying their debts. The value of a bond would be significantly affected if the issuer either refused to pay or was unable to pay.

May encounter liquidity constraints from time to time. The spread between the price you buy and sell shares will reflect the less liquid nature of the underlying holdings.

May invest in companies listed on the Alternative Investment Market (AIM) which is primarily for emerging or smaller companies. The rules are less demanding than those of the official List of the London Stock Exchange and therefore companies listed on AIM may carry a greater risk than a company with a full listing.

May invest in smaller companies and may invest a small proportion (less than 10%) of the Fund in unlisted securities. There may be liquidity constraints in these securities from time to time, i.e. in certain circumstances, the fund may not be able to sell a position for full value or at all in the short term. This may affect performance and could cause the fund to defer or suspend redemptions of its shares.

May, under certain circumstances, invest in derivatives, but it is not intended that their use will materially affect volatility. Derivatives are used to protect against currencies, credit and interest rate moves or for investment purposes. There is a risk that losses could be made on derivative positions or that the counterparties could fail to complete on transactions. The use of derivatives may create leverage or gearing resulting in potentially greater volatility or fluctuations in the net asset value of the Fund. A relatively small movement in the value of a derivative's underlying investment may have a larger impact, positive or negative, on the value of a fund than if the underlying investment was held instead. The use of derivative contracts may help us to control Fund volatility in both up and down markets by hedging against the general market.

The use of derivative instruments that may result in higher cash levels. Cash may be deposited with several credit counterparties (e.g. international banks) or in short-dated bonds. A credit risk arises should one or more of these counterparties be unable to return the deposited cash.

Outside of normal conditions, may hold higher levels of cash which may be deposited with several credit counterparties (e.g. international banks). A credit risk arises should one or more of these counterparties be unable to return the deposited cash.

May be exposed to Counterparty Risk: any derivative contract, including FX hedging, may be at risk if the counterparty fails.

Do not guarantee a level of income.

The risks detailed above are reflective of the full range of Funds managed by the Sustainable Future Team and not all of the risks listed are applicable to each individual Fund. For the risks associated with an individual Fund, please refer to its Key Investor Information Document (KIID)/PRIIP KID.

The issue of units/shares in Liontrust Funds may be subject to an initial charge, which will have an impact on the realisable value of the investment, particularly in the short term. Investments should always be considered as long term.

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