World Earth Day: 'Green' stocks reflect a greener tomorrow

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Today marks the 51st anniversary of World Earth Day; a day dedicated to educate and activate the environmental movement worldwide. The theme this year is 'Restore Our Earth' and focuses on the emerging green technologies and innovative thinking that can restore the world's ecosystems and facilitate decarbonisation.

The world needs to decarbonise fast and investors must play a major role in supporting this change. The transition to a green economy is being led by green technology companies, all of whom are vital players to help achieve the global goal of net zero emissions by 2050.

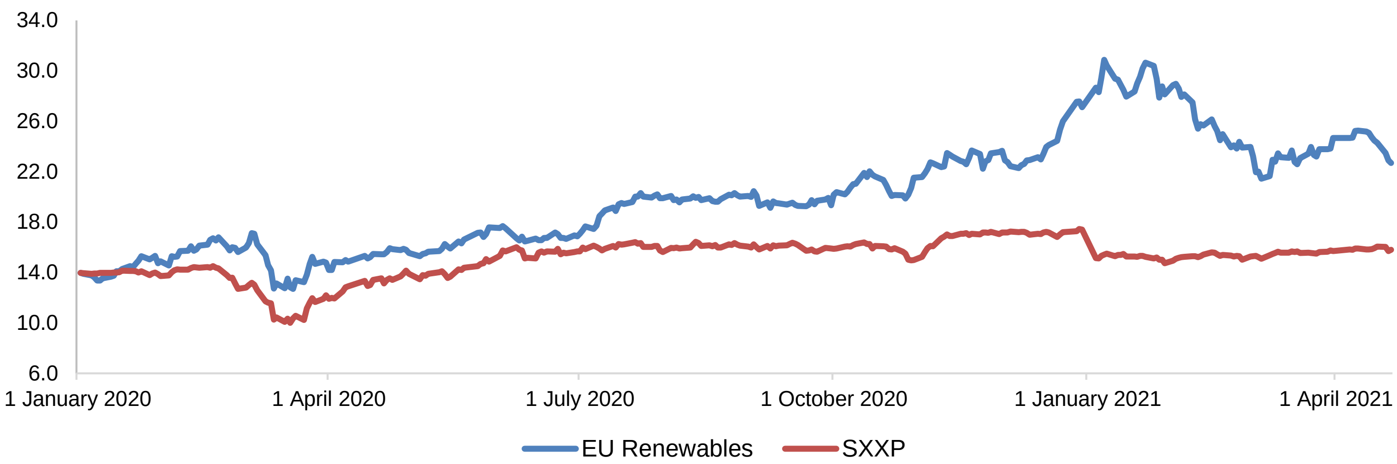
This blog explores the 'green' premium for companies exposed to the decarbonisation of the world. We believe valuations are supported by improving fundamentals and visible, long term growth which will continue for decades to come.

Introduction

The world is transitioning to a sustainable and green economy at an accelerating pace. The recent flurry of political advancements can highlight this; Biden has announced a US$2trn deal to fund sustainable infrastructure projects, the EU Green deal has set out €1trn towards sustainable investments and China has targeted net zero carbon emissions by 2060. Even today, at Biden's virtual Earth Day Summit, the US accelerated plans to cut emissions by 50% by 2030 and Japan increased its goal to 46% reduction of greenhouse gases by 2030 (vs 26% before). All these announcements point to a significant expansion of a global green market and has fuelled investor appetite for sustainable technologies and environmentally friendly companies like renewables, electric vehicles and many others. This has been reflected in the recent run of 'green' stocks, with the renewables sector reaching record highs at the beginning of 2021.

However, the more recent correction of renewables presents the question - is this a 'green' bubble bursting or are there signs of a fundamental future opportunity? This is what this blog will explore. We believe that the 'green' premium is driven by improving and superior fundamentals and 'green' stocks are vital in creating a step change towards the decarbonisation of the world.

EU renewables - 12m forward P/E comparison vs. STOXX Europe 600



Source: Fidelity International, Bloomberg, as at 21 April 2021.

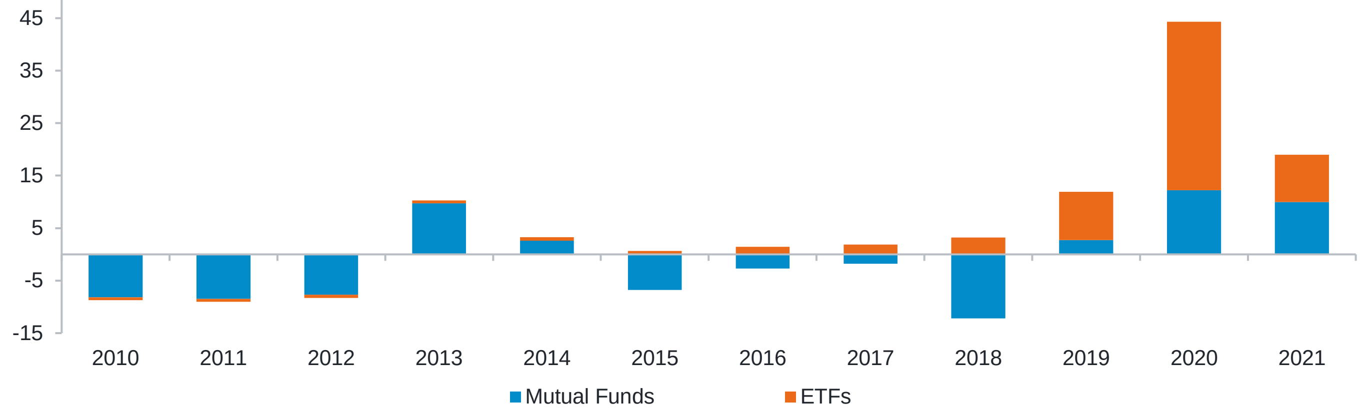
The driving factors behind current valuation premiums for 'green' stocks

In addition to the strong economics of some green technologies, there are two other important key drivers behind the valuations of 'green' stocks: acceleration of ESG flows and recent decarbonisation global regulation.

Acceleration of ESG flows

A key driving factor behind the 'green' premium is the dramatic acceleration of flows into ESG focussed investments. As highlighted in the chart below, 2020 was by far the most successful year for ESG flows, totalling US$45bn (nearly 5 times that of 2019). This momentum continued into the first two months of the year, having already exceeded flow levels as of 2019. Furthermore, a recent empirical study has shown a positive relationship between ESG ownership and stock performance.[2]

ESG-Focused Mutual Funds and ETFs Annual Net Flows

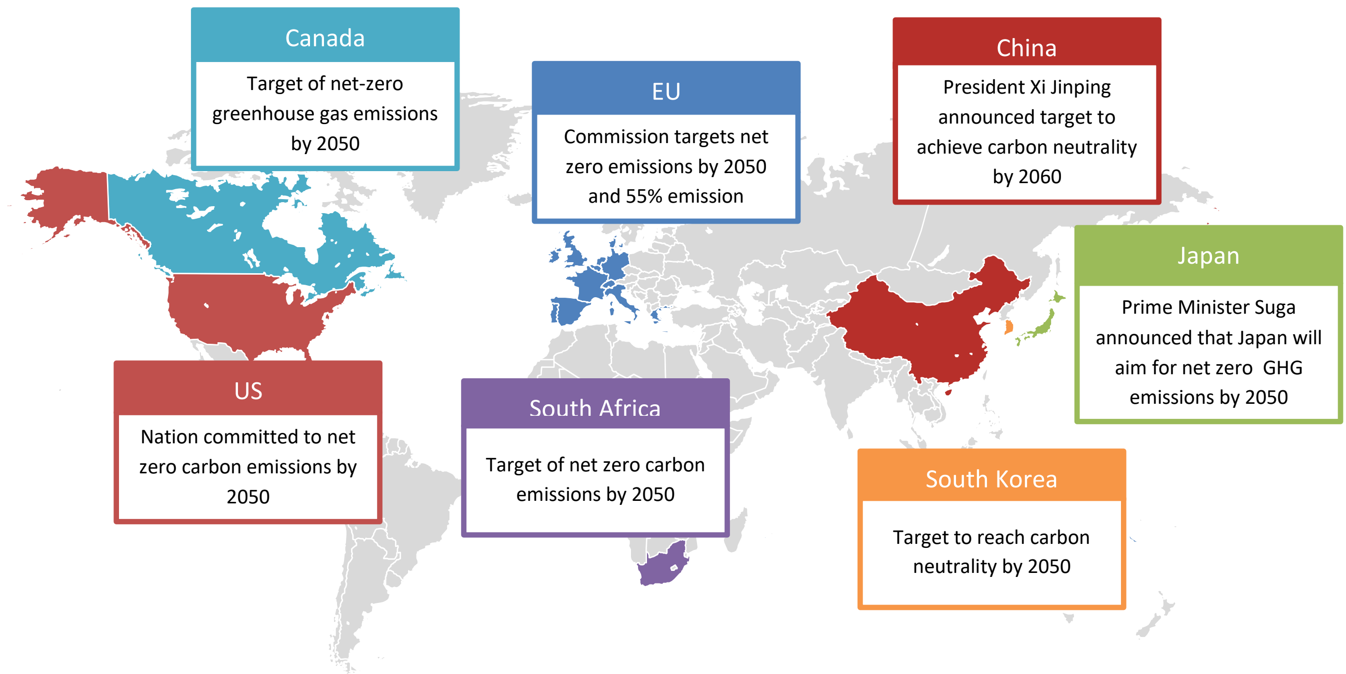


Source: ISS Market Intelligence, Empirical Research Partners Analytics, as at 28 February 2021.

Decarbonisation global regulation has shifted investor focus towards clean energy

As a result of the ongoing climate change debate, zero carbon targets have been set globally to decarbonise the word (as highlighted in the graphic below). This trend can also be identified at a company level, as according to Fidelity analysts, almost a quarter of all companies will be carbon neutral by the end of this decade[1]. Innovative technologies for decarbonising the world are clear beneficiaries from this regulation as it accelerates the adoption of these low carbon solutions. This has led to strong performance as investors are recognising the potential for these businesses.

Global decarbonisation policies



Source: Fidelity International, 2021.

The justifications behind the 'green' premium

The 'green' premium is justified by empirical analysis

A recent study[2] investigated whether an ESG bubble can be detected, due to the acceleration of flows and the existing 'green premium' within the market. This involved using a basket of broad ESG leaders (identified as those which appear most prominently in investors' portfolios) and included many stocks exposed to the decarbonisation trend. The key conclusion was that no bubble was apparent. ESG leader valuations were justified due to higher ROIC's and free cash flow margins vs. their less ESG focused peers. This is consistent with recent Fidelity analysis, where stocks with strong Fidelity ESG ratings led to strong performance.[3]

Decarbonisation presents visible, long term drivers which will span for decades to come

Our research has shown that the 'green' valuation premium is justified due to visible, structural growth drivers which will span for decades to come as a result of the decarbonisation of the world. Improving economics, favourable regulation, changing consumer preferences, and the accelerating pace of green solutions and innovation are all long term, structural drivers for green energy companies. Stocks that are exposed to these trends, while at the same time benefit from favourable competitive dynamics and high barriers to entry, will be in the best position to offer strong and sustainable earnings growth and returns, and therefore outperform the market.

Renewables are the perfect example to highlight the strength of the decarbonisation trend. We need more than 20X the renewables we have today if we are to fully decarbonise by 2050[4]. Renewables costs have declined >80% over the last 10yrs and this reduction in cost will further accelerate wide scale renewables adoption.[4] The investment opportunity is huge. This is also the case for electric vehicles (EVs). EV volumes are set to increase by more than 16x by 2030.[4] This is driven both by a supply push (tougher emission standards will be impossible to meet without electrification) and a demand pull (EV subsidies are significantly reducing the cost of EV adoption and substantial charging infrastructure expansion is required). Investment opportunities therefore lie across the EV chain, ranging from the auto makers, semi-conductor companies and charging infrastructure companies, to facilitate this level of growth. We are at the tipping point of the EV penetration story and global penetration is set for decades.

What does this mean for stock pickers? Are there areas that should be avoided?

Despite these favourable dynamics, there are some areas of 'frothiness' in the market, particularly where technological advantage is questionable or intense competitive dynamics are likely to lead to severe price competition. Such stocks can be found along the renewables, green hydrogen, and electric vehicles value chains, which is why stock picking is crucial. An example of this can be highlighted within the solar sector. JinkoSolar is the world's largest solar panel manufacturer. Whilst solar insulation volumes increased by c.500% over a 10-year period, industry revenue growth was low, as a result of declining module prices (by c. 80%) due to high competition.[4]

The leading investment opportunities within the decarbonisation trend are therefore those operating in industries with high barriers to entry and attractive competitive dynamics, as a result of superior decarbonisation technologies or innovation. By favouring companies with a leading competitive advantage, pricing power can be protected. This results in high returns which can be compounded to provide sustainable value over the long term. Furthermore, capital light business models remove the high risk of cost overruns or inefficient cost control, as can be seen in the early stages of development of some capital-intensive technologies.

Conclusion

Climate change has prompted decarbonisation policies around the world to help achieve global carbon neutrality. The world needs to decarbonise urgently, at a faster pace that we have seen to date and investors can play a major role in supporting this change. The current 'green' premium for many stocks exposed to the green economy transition are justified due to several key structural drivers and improving fundamentals. The decarbonisation trend is currently at the early stage of penetration and will be driven by a combination of innovation, improving economics, accelerated governmental support and changing consumer behaviours; all in response to climate change. It is the stocks exposed to these themes, but with the superior technologies and favourable competitive dynamics, that will drive strong investment opportunities for investors.

Footnotes

1. Fidelity Analyst Survey, April 2021 - https://professionals.fidelity.co.uk/perspectives/analyst-survey-2021

2. Rochester Cahan, Yu Bai - Empirical Research Partners - March 2021

3. Fidelity International, November 2020 - The clear link between ESG and returns - https://www.fidelityinternational.com/editorial/blog/chart-room-the-clear-link-between-esg-and-returns-bbf01a-en5/

4. Internal Fidelity analysis