

## VT Gravis Clean Energy Income Fund

### COVID-19 Update from the Fund Adviser

**The VT Gravis Clean Energy Income Fund is the best performing energy fund in the IA funds universe, year to date.**

*As at 22 April 2020. Source: FE fundinfo*

#### Fund Objectives

- Aims to deliver a regular income expected to be 4.5%\* per annum after charges
- Preserve investors' capital throughout market cycles, with the potential for capital growth
- Invests in a diversified portfolio of OECD global listed securities including Yield Co Equities, Investment Companies and Equities
- Offers exposure to companies engaged in the generation, provision, storage, supply and consumption of clean energy
- The Fund is managed in line with a Responsible Investment Statement, and all holdings are screened by a third party.

\*This is an unofficial target and there is no guarantee it will be achieved. Per annum by reference to launch price of £1.00 per unit, payable quarterly, one month in arrears.

The sustainable energy association defines clean energy as 'energy derived from renewable, zero-emissions sources ("renewables"), as well as energy saved through energy efficiency ("EE") measures'.



#### Valuations and COVID-19

Valuations at a share price level remain lower than before COVID-19 but there has been a significant and relatively broad-based recovery (certainly among the core of the portfolio). We do believe it is warranted given the underlying resilience of the cash flows to which the companies are exposed and there has been a level of rationalisation among investors.

We see good value opportunities to buy more of some of the Fund's core names at very attractive yields. It is of course a rapidly moving situation, but we think the core companies can recover more fully and more swiftly than broader markets. Given the reduction in interest rates (US, UK etc.) the case can be made that the sector may even re-rate to higher valuations, given the yield differential, although in the UK, power price headwinds will possibly provide some resistance in the near term.

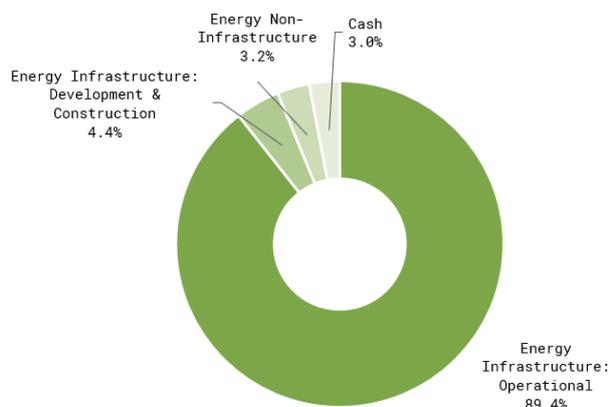
Generally, when valuing closed-ended structures that use a discounted cash flow model we believe investors should focus on the expected return implied from a given share price, rather than arbitrary levels of premium/discount to NAV.

#### The resilience of cash flows

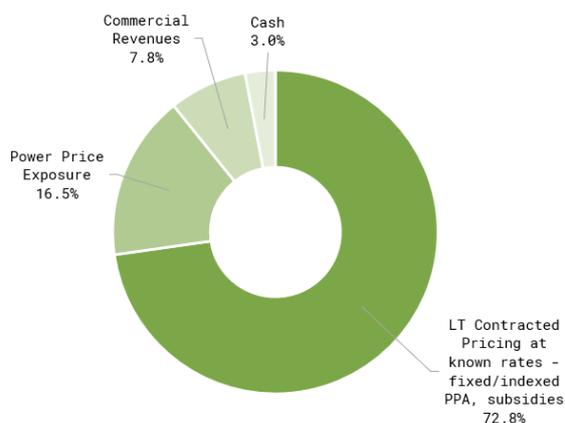
The portfolio is underpinned by companies that own operational renewable energy assets and generate their revenues from the sale of the electricity they produce. While economic activity has contracted significantly and will take time to recover, the demand for electricity should prove relatively resilient throughout this period. Additionally, the majority of these companies have long term contracts in place for the off-taking of the power produced and many benefit from fixed price visibility or an element of subsidy support. These factors ensure cashflows are both dependable and visible.

The Fund aims to maintain a minimum exposure of 80% in operational renewable energy assets. Currently, c.89% of the portfolio is invested in operational renewable energy assets and related energy infrastructure assets. Only c.4% of the portfolio is exposed to development and construction stage energy infrastructure assets, which could be subject to delays and disruption prior to commissioning.

### Operational assets



### Revenue characteristics



#### Gravis analysis

From a revenue perspective, a sizable portion of the Fund (73%) is supported by contracted pricing at known rates. This portion is comprised of fixed/indexed Power Purchase Agreements (PPAs) (of up to 20 years) with high quality counterparties in the US and Canada, for example, and subsidy support – particularly in the UK. Illustrated above is a revenue breakdown based on whole of life cash flows, showing that 73% of underlying revenues are derived from predictable rates for the duration of their operation. In addition, many of our UK names sell forward a proportion of power price exposure for 1-2 years at fixed rates. This means in reality that total power price exposure is lower over the near term.

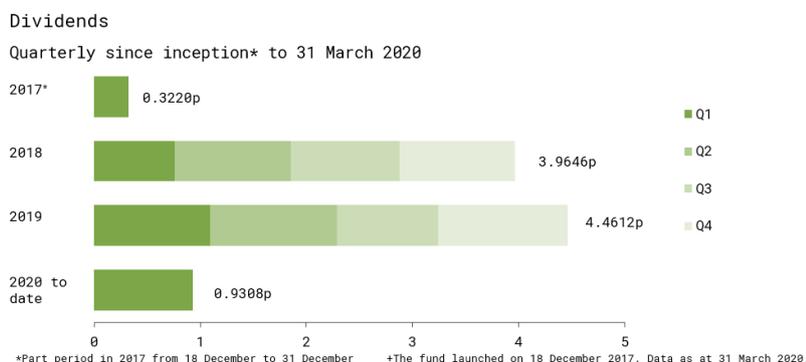
The bias towards operational infrastructure assets underpinned by long-dated contracted pricing supports resilient and dependable cash flows.

### Dividend reliability

The Fund targets a 4.5% net yield (paid quarterly, unsmoothed). This target was achieved in 2019, however at the start of the year we provided guidance that achieving the yield objective on the starting price at the beginning of 2020 would be challenging given strong capital performance.

However, we do believe absolute distributions can grow year by year, meaning the Fund would deliver more than 4.5p in 2020. This growing absolute distribution is supported by the fact that there are a few relatively newly launched companies in the portfolio, listed in London in the last 12-18 months, which are building up to a more mature distribution rate.

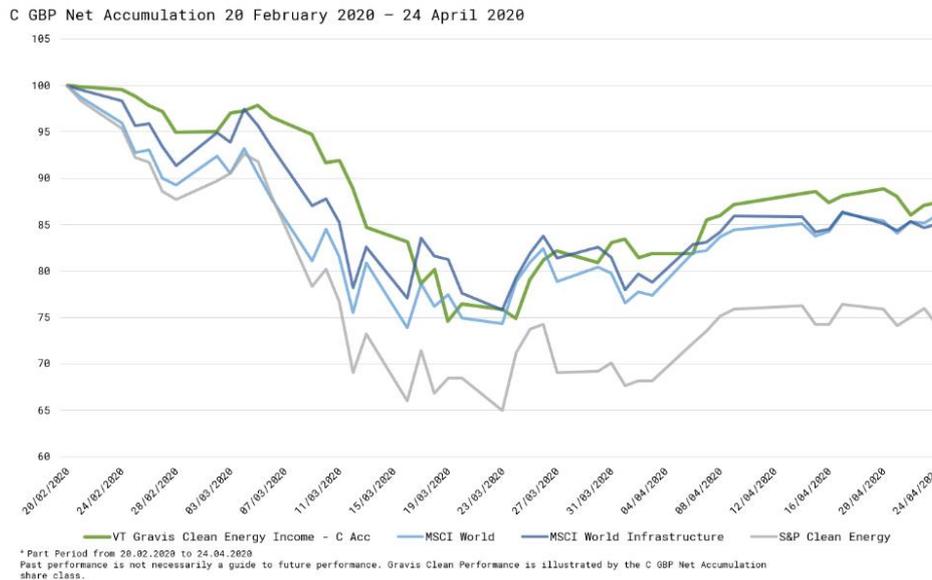
Additionally, as a result of strong inflows and recycling of cash from a recent takeover, we have been able to acquire more of several core holdings at significantly improved yields. We have been able to reinvest cash amounting to approximately 12% of the portfolio NAV at levels that are beneficial to the Fund's future yield.



In the current environment of dividend cuts and suspensions it is important to highlight the Fund's dividend reliability:

- 86% of portfolio holdings by weight have reaffirmed or declared near term dividends in line with expectations which is what we would anticipate from companies underpinning the portfolio which own operational contracted renewable energy assets with resilient cash flows.
- One company (1.6% by weight) has reduced its next quarterly dividend in order to provide greater financial flexibility; this company is not a core position.
- Those that have not yet provided guidance include companies expected to reaffirm imminently and companies that would not typically comment ahead of scheduled announcements. These companies are outside the names we consider core to underpinning the Fund's distribution.

## How did the Fund perform during the recent sell off?



We expect the Fund to demonstrate lower volatility compared to global equities, which has been the case since inception, and to provide lower beta exposure. The chart above shows how the Fund has behaved in this manner thus far, since markets started to sell off in February, outperforming the MSCI World, MSCI World Infrastructure and S&P Clean Energy.

While risk assets have recovered somewhat, markets remain fragile as the ultimate longer-term economic fallout of COVID-19 is far from understood. However, we believe that the Fund is in a good position to recover more fully in the near term, providing a more V-shaped recovery when compared to broader markets. This is due to the Fund's underlying exposure to long-dated contracted cash flows, discussed above.

### UK Renewables discounted cash flow sensitivities

Factor Sensitivity	Impact on NAV for +/- move in Factor	Impact Level	Near Term Direction of Factor
Power Prices	+/-	High	Down = -ve
Production (Energy Yield)	+/-	High	Up vs. budget = +ve
Discount Rate (long-term bond yields, secondary market valuations, political risk, asset de-risking)	-/+	High/Medium	Modest reduction = +ve
Inflation	+/-	Medium	Unchanged
Asset Life	+/-	Medium/Low	Incremental extensions = +ve
Value Enhancement Initiatives		Medium/Low	Favourable refinancing, PPA improvements, lower O&M costs

#### Gravis analysis

The table above shows some of the key sensitivity exposures and our near term expectations around the direction of these factors and how that relates to asset valuations. It is most relevant to UK-focused names in closed-ended structure which represent c.33% of the portfolio.

We believe that asset valuations will prove resilient to headwinds caused by the COVID-19 pandemic. The factor most likely to have a negative impact on NAV is a reduction in power prices although short term price falls have been caused by pandemic-driven economic factors rather than a long-term structural shift in the UK power price curve.

It should be noted, however, that owner/operators of renewable energy assets typically derive very little of their near term cash flows at spot prices. In the UK, for example, subsidy payments often underpin 50-60% of cash flows while a significant amount of the remaining exposure to the sale of electricity is often sold forward, giving additional cash flow visibility over the next 1-2 years. Companies fix prices at opportune times as part of an ongoing process and it is considered probable that they will be looking for a recovery or a period of firmer pricing (vs. today) before seeking to lock in more forward sales. In the US and Canada, for example, it is different. Owner/operators often have no commodity price risk since long-dated fixed price Power Purchase Agreements (PPA) are commonplace. These PPAs are struck at a pre-determined price for the output generated over much of the life of an asset, thereby providing highly

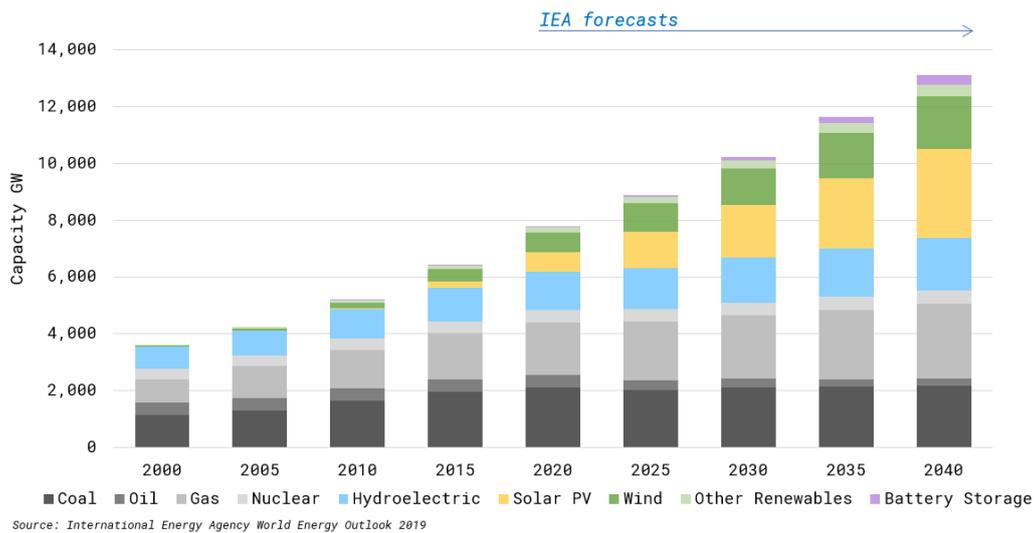
visible and stable cash flows. Currently 73% of the portfolio is exposed to these types of contracted pricing.

Highlighting a few of the other NAV sensitivities:

- Production – The Renewables Infrastructure Group and Greencoat UK Wind have reported production levels that are approximately 20% over budget for Q1. This is particularly important as Q1 tends to contribute disproportionately to full year revenues for each of these companies and provides good read across for the performance of other UK wind power assets.
- Discount rate – generally in the near term we expect a modest reduction in the discount rate reflecting the falls in UK long term government bond yields among other factors.
- Inflation – we do not anticipate any significant changes to near term or long term inflation expectations.
- Asset life – asset life extension has recently been a driver of valuation uplift. We expect this to be more muted in future however some incremental extensions may occur which would be positive.

### The Clean Energy pipeline

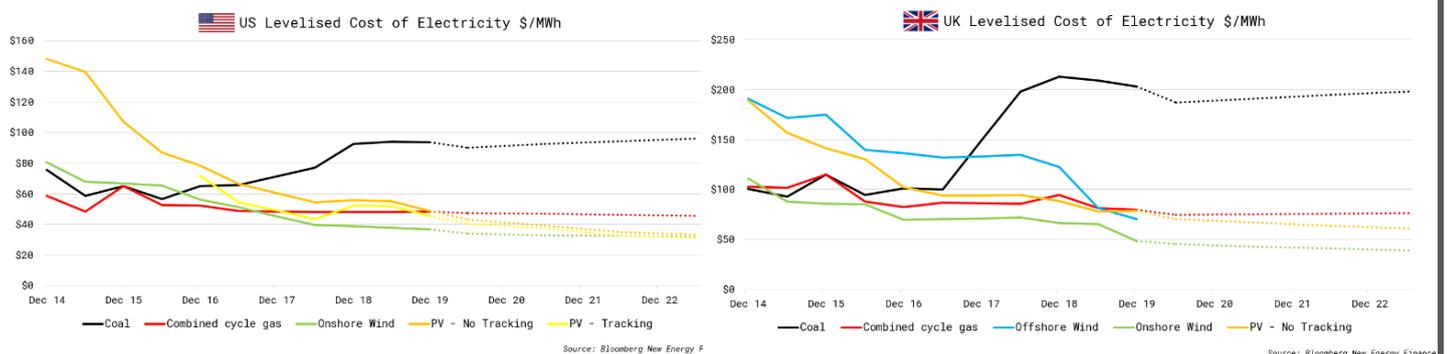
Significant growth in overall electricity generation capacity (>60%) is required to meet the increase in demand over the next 20 years. An expected \$10 trillion of investment is forecast between 2020 and 2040 into renewable energy, with wind and solar the major areas of expenditure.



The International Energy Agency (IEA) forecasts that low carbon power sources will provide more than 50% of global electricity by 2040, and by 2050 wind and solar alone will account for 50% of the electricity supply mix. These forecasts are made under the 'Stated Policy Scenario', based upon commitments made by governments worldwide.

These commitments are insufficient to achieve the Paris Climate Change Agreement's objective of holding global average temperatures to 2°C above pre-industrial levels. In order to meet these targets we expect the level of investment to be significantly higher than the forecasts provided by the IEA.

In addition to national climate change commitments, the build out of renewable energy power generation may afford countries a degree of energy independence and security, which will be viewed politically as beneficial. Beyond increasing renewable energy capacity as a result of government policy, it is important to note the economic viability of new build renewable energy capacity (across a range of generation types) versus conventional, less sustainable forms.



The two graphs show the levelised cost of electricity, a means of standardising the cost of different forms of electricity generation during the life of an asset.

It is evident that in both the US and the UK the cost per MWh of generating solar, onshore wind, and offshore wind (UK) has fallen below coal, and more importantly combined cycle gas, the most efficient form of conventional generation. The renewable energy sector is not dependent solely on government support and subsidies, it is economically efficient in its own right.

The increasing economic viability of renewable energy generation is evident when looking at the clearing price from last year's UK Offshore Wind capacity auctions (for electricity to be delivered in 2023). This was around £40/MWh compared to £57.50/MWh in 2017. Comparatively, with inflation, the electricity generated by Hinkley Point C will cost over £100/MWh upon delivery.

Generally, there is a large global opportunity for clean energy and a large pipeline of new renewable energy capacity. This is driven by the decarbonisation theme, general political targets and legal commitments. Renewable energy is now also economically viable and socially preferable to new build conventional generation capacity.

### **The impact of the low oil price on the clean energy sector?**

Typically, lower oil prices will drive lower natural gas prices. Gas is the marginal cost source of power generation in the electricity mix and so lower gas prices will typically lead to a reduction in baseload electricity prices. This is a clear headwind to revenues derived from the sale of power into the wholesale market at spot prices. If lower prices are perceived to be persistent dynamic it may cause a downwards shift in medium-to-long-term electricity price forecasts and which may impact the present value of future cash flows and ultimately the NAV of companies that use a discounted cash flow model (as discussed above).

As mentioned around 73% of the portfolio benefits from long term price visibility. Additionally, we believe the decarbonisation trend will continue to gain traction globally regardless of the trends in fossil fuel prices/cost of carbon. Many governments are subject to legally binding commitments to reduce emissions considerably over the next 30 years and building out renewable energy capacity is a critical component of that process. On top of this, renewable energy generation sources (particularly wind and solar) have seen their cost curves come down sharply to levels where they are economically competitive with conventional forms of power generation.

Periods of lower fossil fuel prices may reduce the level of competitiveness from time to time but the world's green agenda is not purely driven by relative costs and is unlikely to be derailed or slowed materially by lower fossil fuel prices. The cost curve for wind and solar will also continue to fall over time.

## Investment Manager and Dealing

Valu-Trac Investment Management Ltd

01343 880217

Valu Trac Dealing

01343 880344 cleanenergy@valu-trac.com

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<b>Investment Adviser</b>	<b>Will Argent</b>	Fund Adviser	020 3405 8552	william.argent@graviscapital.com
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<b>Distribution</b>	<b>William MacLeod</b>	Managing Director	07836 695442	william.macleod@graviscapital.com
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<b>Ollie Matthews</b>	Sales Director	07787 415151	ollie.matthews@graviscapital.com
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<b>Robin Shepherd</b>	Sales Director	07971 836433	robin.shepherd@graviscapital.com
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<b>Nick Winder</b>	Sales Director	07548 614184	nick.winder@graviscapital.com
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<b>Cameron Gardner</b>	Sales Manager	07835 142763	cameron.gardner@graviscapital.com
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