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Weekly Commentary

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By Charles Marleau CIM® and William Mitchell CIM®

Opportunity Abounds in Renewable Energy

It would be an understatement to say that renewable energy stocks in Canada have felt the pain from eighteen months of central bankers aggressively raising interest rates. As interest rates rise, the widely held assumption is that the increased cost of financing new projects will prohibitively impact bottom lines. On top of rising rates, inflation, geopolitical stress, and market volatility continue to embolden the bearish camp. Renewable energy infrastructure companies are currently trading at absurdly low levels given that these companies are considered “defensive” given their low correlation to the broader market (i.e., lower Beta). In our view, “renewables” trading like “high beta” stocks makes little sense.

Let’s simplify how projects are financed. Company “X” embarks on a long-term project, let’s say 10 years, in partnership with a government contract. Company “X” finances the project for 10 years until completion at which point revenues begin to pay off the interest and principal (like a mortgage). As the project matures, debt gets amortized with the outcome being a rise in the project's cash flow yield. Importantly, project financing is usually “non-recourse” which means the debt is project-specific and not tied directly to the company. In addition, rising interest rates have a minor impact on existing project financing because the rates are normally fixed for the duration of the project's term.

Supportive of the renewable sector’s long-term prospects are government initiatives to fight climate change by incentivizing decarbonization, which aims to drastically reduce the use of fossil fuels in the electricity generation industry. The U.S. **Inflation Reduction Act (IRA)** of 2022 represents major legislation enacted to combat climate change in the U.S. while also directing significant investment dollars and offering tax incentives to the “green economy”. The initiative will broadly impact the renewable energy industry in North America. Developed nations around the globe are enacting similar initiatives and Canada is no exception.

As for specifics, three Canadian companies come to mind. **Northland Power Inc. (TSX:NPI)** is a Toronto-based producer of electricity through its wind, solar, clean natural gas, and biomass facilities. NPI has a market cap of $5 billion and a dividend yield of around 6%. We wrote about NPI in our October 2 weekly. **Boralex Inc. (TSX:BLX)** is a Quebec-based producer of electricity via wind power (80% of sales), hydroelectric, thermal, and solar assets located in Canada, the Northeastern U.S. and France. BLX has a market cap of $2.6 billion and a dividend yield of 2.6%. Finally, **Innergex Renewable Energy Corp. (TSX:INE)** is also a Quebec-based operator of hydroelectric facilities, wind farms, and solar farms located in Canada, the U.S., France, and Chile; INE has a market cap of $1.8 billion and a dividend yield currently exceeding 8%.

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When evaluating these companies using an appropriate discount rate is crucial. Recently, industry analysts have been applying a *discount rate** of around 12%, which is excessively high in our opinion, relative to the U.S. 10-year Treasury Bond rate which as of Friday's close hovered around 4.9%. We believe a "fair" discount rate should be between 8% and 8.5%. A normalization could easily see a rise of 40% or more from where we are today. Let's not forget that the sector has traditionally been labelled a "safe haven" given predictable returns that generally remain sustainable even during times of turmoil.

There are several catalysts on the horizon. While rising rates have without question been a headwind, central bankers have recently "softened" their stance on rising rates. Although Fed Chair Powell has reiterated his "higher for longer" position, we believe the worst is likely behind us as data are clearly suggesting that progress is being made in the campaign to defeat runaway inflation. This is good news for interest rate sensitive sectors like utilities and REITs. Recent drawdowns are also being driven by traders whose momentum driven algorithms fuel fear and uncertainty. In our experience, extreme oversold conditions often transition sharply to aggressive buying once the bears lose steam. Bottoms often occur when pessimism is rampant and the bears are in control.

The optimal time to purchase anything is when prices are discounted. Warren Buffet, considered by many to be the savviest investor of all time, once said ***"whether we're talking about socks or stocks, I like buying quality merchandise when its marked down**."* All three of the stocks mentioned above are currently trading at multiyear lows. Technical indicators (i.e., the charts) indicate extreme oversold conditions and as we've learned from experience such conditions do not persist eternally. While patience will be required, we see great value in these stocks, and we've been adding all three to our positions in the **Palos Income Fund LP** and the **Palos Equity Income Fund.** The **Palos-Mitchell Alpha Fund** recently added Northland Power to the portfolio.

**The discount rate is the interest rate or percentage used to calculate the current value of future cash flows or payments. It's a commonly used method of determining the present worth of money you expect to receive in the future. By applying a discount rate, you're essentially saying that a certain amount of money received in the future is worth less than the same amount received today. This concept is used to evaluate the value of investments, projects or cash flows over time."*

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Chart 1: Palos Domestic Funds versus Benchmarks (Total Returns) [1]	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL100	$7.63	-0.57%
Palos Equity Income Fund - RRSP	PAL101	$6.36	-1.18%
Palos WP Growth Fund - RRSP	PAL213	$9.91	-20.35%
Palos-Mitchell Alpha Fund [3]	PAL300	$10.13	28.65%
S&P TSX Composite (Total Return with dividends reinvested)			1.25%
S&P 500 (Total Return with dividends reinvested)			11.45%
S&P TSX Venture (Total Return with dividends reinvested)			-8.49%
Chart 2: Market Data [1]			**Value**
US Government 10-Year			4.91%
Canadian Government 10-Year			4.07%
Crude Oil Spot			US $88.75
Gold Spot			US $1,982.50
US Gov't10-Year/Moody BAA Corp. Spread			181 bps
USD/CAD Exchange Rate Spot			US $0.7291

[1] *Period ending October 20th, 2023. Data extracted from Bloomberg*

[2] *Fund is priced annually*

[3] *Fund is priced weekly on Tuesdays*

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