Investors' Chronicle | Alpha

Alpha Editor: James Norrington
Alpha Production Editor: Sameera Hai Baig

Alpha shares analysis

16 December 2021

Selecting the right tool

When determining whether a stock is cheap or dear, it is important to look at the right metric. While the PE ratio is the dominant guide to valuation, it can mislead. In some cases net asset value (NAV) is the primary measure, for other companies with a large gap between profitability and cash flow it is better to consider earnings before interest, taxes, depreciation and amortisation (Ebitda) ratios. PE ratios can be flattered by short-term and/or fully external phenomena which lower the quality of earnings. In this week's report we encounter examples where different valuation techniques and ratios are most applicable and work through how value (or otherwise) is best determined.

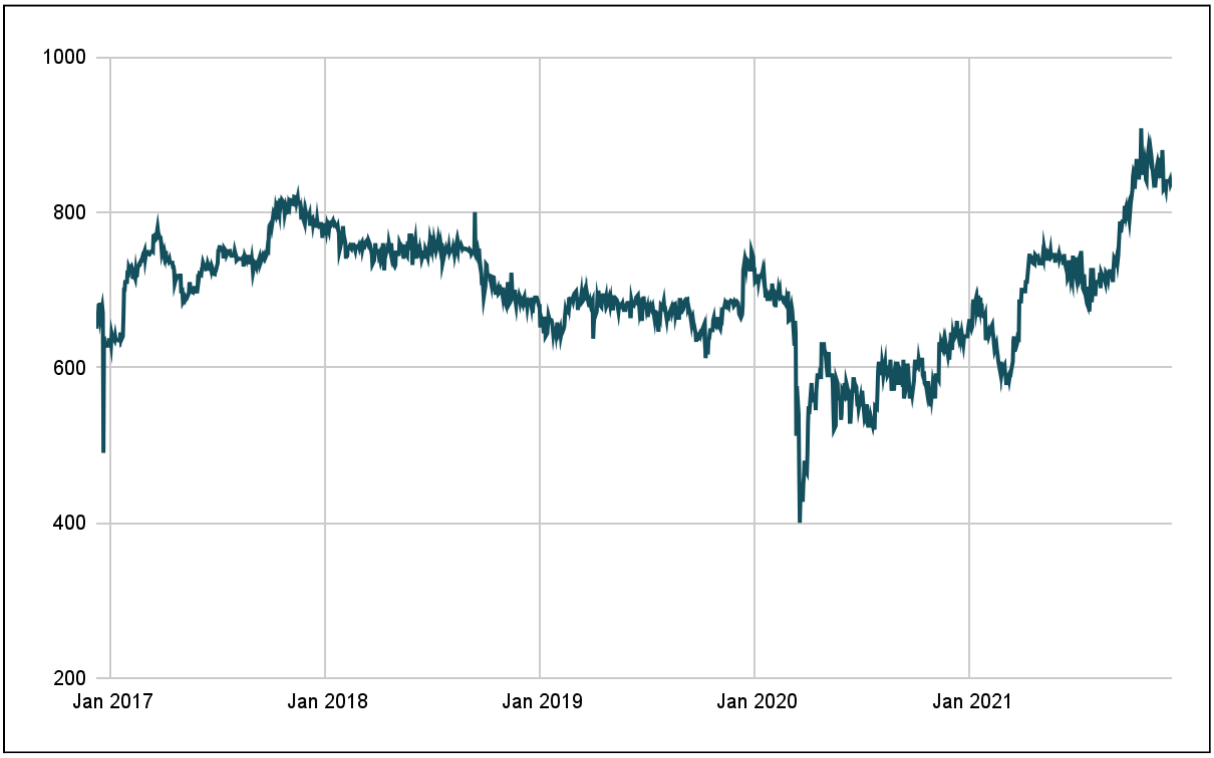
- **MP Evans (MPE)** – this Indonesian-based palm oil producer is riding a mini commodity cycle in cooking oils where Covid-enduced shortages have caused a price surge that might remain through until 2025. Palm oil production has had a poor reputation, but the industry is evolving with sustainable producers such as MPE now achieving high ESG scores. While the shares may look relatively cheap (14x PE), the profit surge is based on windfall and that does lower earnings quality, but four years of stepped-up dividends from those higher earnings is attractive.

- **JD Sports (JD.)** – the UK's leading sports retailer has an impressive trading and share price history with a 30-fold increase in the share price over 10 years and 10-fold revenue increase. However, greater scale does begin to drag on growth and after a step change in EPS this year, growth is forecast to drop to just 6 per cent per annum through to 2024. While a near 20x PE looks pricey, the shares are best valued using EV/Ebitda. On this basis, JD looks inexpensive on less than 7x, but Omicron still has scope to ruin the party for retailers and the shares have de-rated accordingly. Cheaper buying opportunities may lie ahead.

- **Greencoat UK Wind (UKW)** – a specialist investment trust focused on UK wind farm assets where, like most non-equity based trusts, it is harder for investors to understand movements in the all-important NAV. Higher electricity prices are a positive, as is higher general inflation, but with a large amount of debt, rising interest rates are an issue as are higher discount rates for setting the net present value (NPV) of wind farm assets. The shares might look cheap on a PE of 7x, but earnings are not the driver here, it is NAV growth and while that appears likely, it is far from certain: a reliably over 5 per cent yield does have some attraction, however. Another potential issue here is a low ESG score, perhaps unexpected for a green energy stock.

Analyst: **Robin Hardy**

MP Evans – Wow!



Source: FactSet

When Indonesian-based palm oil producer **MP Evans (MPE)** published its half-year results on 13 September, all that Peel Hunt's stock analyst Charles Hall could say was: "Wow!". Expectations for 2021's profits had already been raised in July when the trading update showed stronger than expected production and, coupled with the surge in the palm oil price, investors were set for a bumper year. Even so, the half-year results led to strong upgrades because not only had the top line been strong, but MPE had also shown great cost controls. The net result was half-yearly profits rising by over 550 per cent against H1 2020 and Peel Hunt raised its forecasts for the full year 2021 by 57 per cent.

Much of the increase in profits here came from the surge in the crude palm oil price, which has more than doubled and is 50 per cent higher than the previous peak level measured over 10 years. Palm oil futures indicate that today's high prices are likely to remain intact. While palm oil has long been popular as a source for vegetable cooking oil (palm oil accounts for around 40 per cent of the world's cooking oil and is used in the production of myriad food products), the market dynamics have changed.

A number of forces have been at play here: shortages of soybean oil in China during 2021 causing a search for alternatives, US soybean production has been hit by severe droughts with a similar experience in Canada for canola (rapeseed) and manpower shortages on many soybean plantations have meant that vermin or insect infections have allowed a material amount of the crop to spoil. All of these factors have strengthened palm oil as a food product and driven demand and pricing. Other issues have emerged with palm oil starting to be used in the manufacture of biodiesel. Another advantage for Indonesian producers has been the lower use of migrant workers, while other growing nations (especially Malaysia) have experienced labour shortages as many foreign workers have been unable to return due to the pandemic.

The impact of market prices on MPE's trading has been slightly blunted by the imposition of higher export tariffs by the Malaysian and Indonesian governments. This means that while market prices in H1 of 2021 close to doubled, the factory gate price for the group's crude palm oil was only around one third higher.

Figure 1: Crude palm oil spot price – US$ per ton

Source: FactSet

MPE's strong performance has not only been good fortune or down to a windfall, however. A major factor in the rate of profit increase has been cost controls or rather cost efficiencies, largely due to its own higher scale of harvesting/production and steeply increased utilisation of the group's milling plants. Also MPE significantly increased buy-in from independent growers for milling-only, pushing plant utilisation higher still. Finally, production began to skew more towards newer and more efficient plantations. The net result was that on top of a 29 per cent increase in production and a 34 per cent higher factory gate price, gross margins tripled from 11 to 33 per cent.

A problem with price

Historically palm was an ideal choice because it was generally cheaper than other vegetable oils. While the high price is good for manufacturers in the short term, it must in time make palm oil less attractive, especially for large food manufacturing businesses. This is not a problem right now because of supply issues for other oils and the apparent lack of supply of palm oil, but the issues with other oil bearing plants are likely only to be temporary. Potentially, some food processes stay switched over to palm oil and demand remains at higher than historic levels, but there has to be a material risk that price, through lower demand, will fall back and with that the margins of producers such as MPE.

A controversial crop

Palm oil has long been a controversial and contentious crop. The main issue has been deforestation with millions of hectares of forest in Southeast Asia having been uprooted to make space for palm plantations. Deforestation is a major contributor to climate change releasing CO_2 on clearance and reducing the CO_2 scrubbing effect from trees. This has meant that Indonesia has become the world's 3rd largest net emitter of CO_2. Another problem is soil drainage. Indonesia, for example, naturally sits on swampy peat, but palm trees need dry soil. Drained peat soils are flammable and Indonesia has experienced numerous, large-scale fires that cause local health problems and contribute more CO_2. Wildlife habitats are also destroyed (especially orangutans') and there have been numerous reports of local communities being run off their land by unscrupulous plantation owners. As if that wasn't enough, there are human health concerns about high saturated fat levels in palm oil and its contribution to higher cholesterol levels.

The poor reputation of the industry has led historically to poor share price performance for the likes of MPE – the shares underperformed the FTSE All-Share by 45 per cent in the mid-2010s before the 2016 takeover bid by Kuala Lumpur Kepong and conversion to a sustainable operating strategy exposed value in the stock.

However, the palm oil industry is changing and it has a light side (responsible and sustainable growers) and a dark side (those still doing all of the negative things mentioned earlier). There have been concerted efforts by the likes of Greenpeace, the United Nations Principles for Responsible Investing (UNPRI – a network of investors working together to implement change) and the World Wildlife Fund to name-and-shame food producers that source palm oil from the dark side of the industry and while this looks to be having some impact, there is a long way to go.

MPE stands on the light side of the palm oil industry with a robust sustainability policy, although publication only started in 2020 with actions reaching back two to three years before that. It is a member of the Roundtable on Sustainable Palm Oil (RSPO), a representative body that aims to make all palm oil producers operate in a sustainable manner.

The impact of ESG

Environmental, social and governance (ESG) principles are of growing importance to many investors. The history of the palm oil industry might lead one to assume that MPE and other producers would score very poorly. Not so. While much of the palm oil industry is still running in ways UK investors would be unhappy with (these are mainly privately-owned businesses with less shareholder accountability and, empirically, India-owned producers), the leaders in the field do have strong credentials in environmental, land use and human rights issues: all areas in which the industry has historically been lax. While there might still be some taint from history and from the remaining bad operators, it is perhaps a surprise that this industry is on a much stronger ESG footing than one might expect.

Table 1: ESG score of leading palm oil producers

New Britain Palm Oil *	94.4%
Wilmar International	89.9%
Musim Mas	85.7%
Sime Darby	82.5%
Golden Agri-Resources (GAR) / Sinar Mas	81.2%
MP Evans	76.3%

Source: SPOTT.org | * subsidiary of Sime Darby

Conclusion

The explosion in vegetable oil prices is not limited to palm oil with canola/rapeseed,, sunflower and soybean oils (all doubled to their peak to 2021) also rising strongly. Demand for vegetable oil in total has not increased (relative to GDP or populations), so the problem is supply due to a lack of workers to harvest and process crops in many locations. Coronavirus remains a major issue in less economically-developed countries where vaccine programmes are less advanced plus global warming is visibly having an impact in a number of countries and on a number of crops. Supply issues are not likely to resolve quickly. In addition, major users such as India and China look to have moved aggressively to secure supply and that has exaggerated the price surge.

If this was a storm in a teacup, we would simply say that 2021 (and perhaps 2022) will prove to be spike years and that producers' profits will fall back to levels seen in 2019 and before: in MPE's case that could mean that EPS in 2021-22 of 80p-90p re-bases to closer to 10p-20p. However, that looks unlikely with the World Bank only reckoning on vegetable oil prices stabilising in mid-2022 and staying at, or close to, current prices right through until 2025. There may be some intra-market gyrations between different types of oil but overall, prices for oil and profits for producers look set to remain high for the next four to five years.

For MP Evans' investors this should mean sustained elevated EPS, high dividends and falling debt/rising investment: either in new plantations , buying up smaller producers or increasing stakes (many of which are less than 100 per cent owned) in its operating business. After a rise of 166 per cent this year, many forecasts are for profits to flatline and as we approach 2025-26 forecasts (which should emerge in around 18 months' time) should be expected to drop. That is likely to mean that in or around mid-2024, the share price could begin to slip, perhaps to pre-Covid levels of below 600p. That said, this all sits outside the market's 'investment horizon', which tends only to look ahead around 18 months.

The shares have re-rated since the September upgrades, but have risen by 15-20 per cent against EPS forecasts that stepped up by more than 50 per cent. The proportionately lower re-rating is because a lot of the profit increase is regarded as being windfall rather than anything driven by strategy. Windfall earnings are seen as being of lower quality than those driven by management action: windfall earnings are sometimes described as having a 'PE of 1x'.

The shares may not look expensive and a P/E of c.14x against EPS substantially more than doubling this year can be beguiling. Add in a dividend yield over 5 per cent and the stock can appear to offer huge value, but the current performance is not sustainable long term. If EPS in 2026 drops to, say, 25p the PE looking further forward could be well above 30x: if we value the windfall element of earnings on a very low PE, the real rating of the stock is likely already to be close to that level. That is likely to limit performance.

The shares feel unlikely to rise much further (perhaps 5-7 per cent) leaving only the yield to drive total returns: a 5 per cent income is nice but we can be fairly confident this level of income is only temporary. Any investors drawn in by the strong underlying market conditions and the near-term jump in profits need to be sure to keep an eye on the exit and head for it in a maximum of two to two-and-a-half years.

Continued below.

JD Sports - Retail is in the detail

Source: FactSet

JD Sports (JD.) is the self-proclaimed "King of Trainers'' but this is no idle or conceited boast as it occupies the No. 1 spot in the UK for trainers and 'athleisure' wear: in sports retail it has similar revenue to Sports Direct (within Frasers plc), but that business has revenues from other sources such as GAME. It is also notable that in terms of market capitalisation, JD Sports is now second only to Tesco amongst the quoted retailers with a market value of c.£10bn.

Today, the UK (the original core) is around 40 per cent of JD's business with c.30 per cent of revenues arising in the US (following a chain of acquisitions begun in 2018), 25 per cent in Europe and a fledgling business in the Asia Pacific region (mainly Australia).

JD runs c.2,300 stores globally, occupying nearly 9 million sq.ft of retail space. Growth has been rapid with sales in the last ten years rising eight-fold from £880m in 2011 to £6.2bn in 2021. Ebitda has grown more quickly, rising from £77m to £940m in the same time frame. Shareholders have done equally well (the chart above does not fully do this justice) with the share price rising 30 fold since 2011 with total returns only fractionally higher because JD is not a dividend payer. Overall there has been a 41.6 per cent average annual return over 10 years.

JD has a substantial brand portfolio as set out below:

Table 1: JD Sports' brand portfolio and branch numbers

JD Sports	853	19 countries	Sports and athleisure
Finish Line	464	40 US states	Premium sportswear
Shoe Palace	167	US West Coast	Footwear and apparel
Sprinter	163	Spain	Sports apparel and equipment
Sport Zone	107	Portugal	Football and lifestyle clothing
Perry	95	Netherlands	Multi sport, multi brand apparel
Millets	93	UK	Casual outdoorwear
chausport	66	France	Sport and leisure footwear
Go Outdoors	66	UK	Value outdoor Equipment
Blacks	57	UK	Specialist outdoorwear
Tessuti	39	UK	Mens & women's high fashion
JD Gyms	38	UK	Budget gyms
Size?	33	Northern Europe	Early and unique release footwear and apparel
Scotts	20	UK	Sports brand leisurewear
Tiso	13	Scotland	Outdoor equipment
Livestock	4	Canada	Limited release fashion
Fishing Republic	3	UK	Fishing
Naylors	3	UK	Equestrian
Footpatrol	2	UK	Sneakers
Mainline	Online only	Online	Premium men's apparel

Source: JD Sports' Annual Reports 2021

The reason for showing this is not only to gauge the scale and diversity of the business, but also to provide some context for the reason that JD has most recently been in the news: the decision by the Competition and Markets Authority (CMA) to force JD to sell off the Footasylum business it acquired for £90m in April 2019.

While JD's management is "furious" with the decision (it had previously pushed back the CMA on the basis that the pandemic made the true market climate opaque and that it had ignored leading brands' direct sales when measuring competition) some scale perspective is needed. Footasylum has 69 outlets, all in the UK, plus online presence with revenues of c.£250m. Prior to its purchase by JD it was barely profitable (£2m PBT in 2018) which is why the purchase might appear low against these revenues and c.£90m of gross profit. Raising the business to JD's level of returns would, in time, have grown the pre-tax contribution to nearer £25m.

So , being forced to part with Footasylum is frustrating and a lost profit enhancement opportunity, it is relatively small within the JD universe.

Reasons to stay positive

The sale of Footasylum is a small distraction and there are a number of positive drivers that can keep JD moving forwards faster than retail sales more broadly.

Data – JD talks a lot about the quality of its data and how well is it able to use what it knows about its customers, changing trends, buying habits (what breadth of product customers will buy from a single outlet), store formats, store locations and through to what acquisitions will provide the greatest marriage value with the existing estate. It may appear that this should be bread-and-butter for all businesses and one might question how any business can function without knowing and understanding these things.

Disturbingly, many businesses simply blunder and stumble without fully understanding what will make them succeed – we wrote recently about how even a retail giant like Marks and Spencer can fail to apply data flowing through its hands to make itself more relevant to customers or find additional ones. It is clear from both the specific performance at JD and the poor outcomes for many competitors that this is a business that is optimising data very well.

Athleisure – this is the wearing of sports clothing with no intention of any active participation in sport, just leisure. Five years ago wearing sportswear much or all of the time for adults was something of a no-no (less so for teens and young adults), but things have changed, accelerated by coronavirus lockdowns and the rise in working from home. Forbes Magazine recently reports that against a struggling fashion industry overall, athleisure sales rose by more than 7 per cent in the last year. Being a market leader in sportswear, JD has seen a sizable expansion of its available market beyond the core customer base of the under-25s.

Brand strength and supply chains – JD has powerful positions with its key brands (such as Nike and Adidas) that feed through to make it a strong and first choice destination for manufacturers. Across the network JD often has either unique products or early exclusivity on new releases. Manufacturers have shown through the last two years that they are willing to prioritise JD's brands over other retailers meaning that stock availability has remained much better than for the competition in key product areas. Making a substantial move into the US has helped to improve this position significantly.

Perking up the US businesses – JD moved into the US in 2018 through the purchase of national retailer Finish Line and now has over 600 outlets. This helped improve relationships with leading manufacturers, especially those from the US, which has boosted outlets in all locations. The US businesses were not great on acquisition: low margins, high inventory levels, too many loss making outlets (83), some brands had weak online presence, many mis-located stores (half of the total), too much focus on footwear (95 per cent of revenues) and an unhealthy skew to one supplier (80 per cent of sales were from Nike). There is still a lot to improve in the US and this division does look likely to drag on the margin, but the longer-term benefits appear substantial. It may appear that the US businesses have already turned the corner but the very strong recent trading has been put down to consumers spending their stimulus cheques and that momentum is not likely to be sustained.

How to value JD Sports

Growth has been impressive across the past decade and is stepping up very strongly in the current year: forecasts indicate that Ebitda will be around one third higher this year than pre-Covid but after this, estimates begin to grow much more slowly. In the next two years, Peel Hunt (broker to the stock) forecasts Ebitda growth of 6 per cent per annum. That is still a decent rate of growth but not spectacular and well below what investors have seen here historically. So, what about valuation?

The best way to value this business is not to look at the PE, but rather the EV/Ebitda multiple. Why so? Because there are very substantial non-cash charges that wash through the reported pretax profits and earnings: 2021 underlying PBT (excluding exceptional items) was £401m, but this was after deducting £450m of depreciation, £90m of goodwill write offs and £61m of notional interest costs under FRS16. Against that £401m of profit, cash flow totalled £1,062m, a figure very close to the Ebitda.

On this valuation basis, the EV/Ebitda is just 7x this year, dropping to 6.5x two years out, based on Peel Hunt's forecasts that we note are below consensus. Also, JD has been catching analysts on the back foot recently so current market estimates could well be too low. The need to sell Footasylum is unlikely to make much difference to the rating as the EV and Ebitda would both be lowered by a similar percentage. Overall, for the strong market positioning, already reasonable growth expected and history of surprises this rating looks relatively low.

This is not a stock for income with a forecast dividend of just 0.38p (1.9p in old money pre the recent 5:1 share split) for the current year, giving a yield of less than 0.2 per cent. This is unlikely to change as this is a true growth-oriented business, but having said that, at the year there will be more than £1.4bn of cash burning a hole in the balance sheet plus the money likely to flow back from the enforced sale of Footasylum (materially more than the £90m they paid in all likelihood).

The worst decision, in my view, would be for JD to pay a special dividend. As we have discussed at length, that almost always ends up as zero-sum-game for investors. Investors already own that cash and the business would lose investment firepower. Share buybacks are preferable to specials as they boost EPS (which lowers the PE), but do raise the enterprise value and thus push up the EV/Ebitda as this is not a per share calculation.

Investment would be the better option. There is scope for more acquisitions, but clearly that might be a problem in the UK given the CMA's already known position. There could be more diversity either geographically or by end market, but the latter could introduce more risk. JD does like to buy businesses out of administration and there are many good ones under intense financial pressure. The US operations would benefit from more apparel in the mix, but that is needed in the existing stores, not via additional brands, so would just consume some additional working capital. One use would be to repay the £61m that JD has received in Covid-related wage support globally; JD has thus far refused to repay this and there are some rebellious rumblings. That would quiet shareholder rumblings but barely dent the cash reserves.

Inert capital does lower return on capital and that does harm value creation which could be dragging on the rating. JD does need to deploy this capital at some point, but having a large and growing cash pile is a nice problem to have to resolve.

Another issue that might also bear on the rating is the ownership structure. JD Sports has less than 50 per cent free float (tradable shares) because the business is 51 per cent owned by Pentland Group, a privately-owned investment company that is, in effect, an unlisted sports brands investment trust. It owns or controls other leading sports brands Speedo, Berghaus, Canterbury of New Zealand, Ellesse, Endura, SeaVees, KangaROOS, Mitre and Red or Dead. Having a majority stake, it is hard for external shareholders to influence decisions such as equity fund raising, dividend policy or remuneration, all of which can drag on a stock's valuation. Also there is always the risk that such a large single shareholder could begin to influence strategy and undermine the plc management.

As we have looked into ESG on the other two stocks, a quick glance at that measure here. JD fares pretty well on this measure with Refinitiv giving the group a score of 46/100. It scores well on environmental and social but poorly on governance, with the Pentland stake being something of an obstacle. Shoe and apparel manufacturing have histoprically fared badly on areas such as factory/social conditions and child labour but things are getting better and JD looks to be using its strong position with brands to drive further improvements.

Conclusion

Overall, JD Sports is a strong business but at the size it has reached, growth inevitably becomes more difficult. The CMA's decision on Footasylum suggests that core UK growth will become harder or that it will need to head off in a new direction which introduces risk. There is still scope to improve returns in the US and Europe and the latter is a potential area of expansion but the obvious targets are themselves strong businesses that would be expensive and hard to aquire. The shares have dropped more than 10 per cent in the last month and there is now some reasonable value here. The fair value for JD is probably closer to 245p-250p based on an EV/Ebitda of 7½x to 8x, but with uncertainty over how Omicron might impact shopping patterns, and thus profitability, bets are largely off for the retail sector right now and there would be no rush to get involved here.

Continued below.

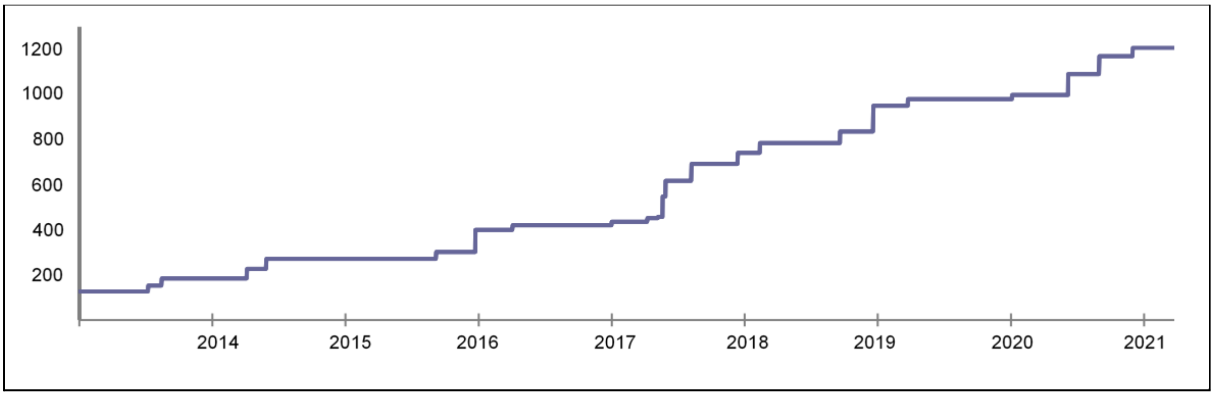
Greencoat UK Wind – blowing hot and cold

Source: FactSet

Greencoat UK Wind (UKW) is a specialist, infrastructure-focused investment trust with a UK premium listing sitting comfortably in the middle of the FTSE250 index with a market capitalisation of c£2.5bn. The fund (of around £3.6bn gross and debt/gearing of £1bn) is externally managed by Greencoat Capital, specialists in infrastructure investment. Unlike some trusts, the external management charges are reasonably low and should not be an obstacle for investors.

The portfolio is primarily composed of onshore wind farm investments (with one offshore asset in the Humber estuary and three in Morecambe Bay) across the four nations of the UK. In terms of electricity output, 70 per cent comes from the onshore farms. Today, there are some 40 assets with a total generating capacity of 1,289MW, a ten-fold increase in the total generating capacity since the 2013 IPO. This makes the fund one of the UK's largest wind electricity providers within the UK's total wind generating capacity of c.26,000MW. The bias towards onshore wind does leave UKW holding what are considered to be less efficient assets, as offshore wind is seen as more consistent and has higher wind speeds. Countering that, however, offshore assets are considerably more expensive to develop.

Figure 1: Greencoat UK Wind generating capacity in Megawatts



Source: Greencoat UK Wind

Wind is a key element in the UK's power generation model, although as we saw this year it can prove unreliable as there is no control over the energy source by generators as there is with nuclear or fossil fuel power plants, a problem wind shares with solar power. In 2020, close to one quarter of the UK's electricity came from wind sources with wind becoming larger than coal in 2016 and passing nuclear power in 2018. The dip in 2021 will see wind drop back to 23 per cent of total UK generation but the trend for wind power remains strongly positive.

Table 1: UK electricity generation sources

	2021	2050
Wind	23%	46%
Solar	4%	9%
Nuclear	19%	26%
Gas	35%	8%
Other *	19%	11%

Source: UK Energy, ONS | * includes imports

Demand for electricity overall in the UK has been falling in the past decade due to increased awareness of environmental impact, low energy lighting, smart meters and the steep rise in the use of more energy-efficient plant and equipment, both domestic and industrial. However, the pendulum began to swing back in 2020 and electricity demand is forecast to rise from c.300 terawatt hours to c.350 TWh by 2030. This is due to the rise in electric vehicles and the growing electrification of heating. Demand would rise further if the aviation industry begins to electrify but this has very long lead times.

Valuation

As an investment trust, the equity valuation is driven by the NAV of the fund and the prevailing level of premium or discount to NAV across the whole investment trust sector. Historically, the long-term average discount for the sector is c13 per cent, but in 2021 the sector's discount averaged only around 3 per cent.

UKW has traded above its NAV since IPO save for two very brief and very minor dips below the book value in 2015 and 2016. Even in the Covid slump in March 2020, the share only fell below the NAV for a total of seven days. At the time of writing, UKW is trading above its last reported NAV of 125p with the shares at 136p.

As with all investment trusts the premium or discount relates to the popularity and availability of stock for investors to buy and green energy stocks are in vogue at present, so a stronger pricing level would be expected. The pressure on the share price from investor demand is somewhat tempered by the steady and substantial issuance of new shares to fund the portfolio of generating assets. So far in 2021, just under £500m of new equity has been issued (note that some of the investment manager's fees are also paid in new shares so not all new equity is used to grow the portfolio, albeit this is small in the overall total).

Table 2: Equity raising history

Year	New equity raised
2020	£394m
2019	£498m
2018	£117m
2017	£335m
2016	£243m
2015	£47m
2014	£158m
2013*	£383m

Source: FactSet | * includes the IPO

Understanding the asset value

UKW is a specialist investment trust which makes it harder to see easily the value of the overall fund than one would expect with an equity-focused trust. The main driver of the asset value is likely to be the retained profits after dividends and some short-term timing differences between equity raises and investment in new assets. In this year's first half, NAV per share rose by 3p (122.3p to 125.3p) or 2.4 per cent, while the total NAV rose by almost 11 per cent to £2.47bn. The movement in the pound notes asset value was primarily due to new equity funds.

Net (post-tax) income is forecast to be relatively flat from 2021 to 2023, not helped by the UK corporation tax rise to 25 per cent in 2023. This means the impact of retained profits on NAV growth will diminish and any growth would need to come via other drivers of the asset value. So, what are the other drivers of the NAV?

Interest rates – there is close to £1bn of debt in this fund (possibly less at this year end due to the second equity issue of £300m coming in late November making it likely to be spent by the period end). While there is extensive use of swaps to fix debt costs, interest is going to consume more of the profits and cash flow than in the past five years as rates rise.

Power prices – UKW has consciously avoided entering into fixed price energy contracts with power companies and this is beginning to look like a shrewd move. Energy prices are rising sharply because of the wholesale cost of gas and while wind generating costs are largely unaffected, there should be some knock on impact for wind generated pricing. A 1 per cent movement in the power price moves the NAV by 0.8p.

Inflation - some of the group's supply agreements are index-linked so the current spike in inflation should boost revenues with a large fall through to profits. While some running costs would increase, there is no energy input cost that can inflate and operating costs are just 12-15 per cent of revenues so there is positive impact here from inflation. Every 50 basis points of additional inflation would boost the NAV by 6p.

Discount rates – each wind farm's value is a discounted future value of net contributions, so the discount rate used in the calculation can swing the asset value. Discount rates were falling for some years, but have now begun to increase as risk-free rates (the yield on government bonds) begin to climb. Every 50 basis point change in the discount rate hit the NAV by 5p. The UK benchmark 10 year Gilt dropped 300 basis points between the 2013 IPO and the mid-2020 low, but have now climbed more than 60 basis points.

Asset life – another key element in the net present value calculation is the asset's generating lifespan. Generally 20 years are expected from a wind turbine but adding 5 years to the lifespan across the whole estate would add 4p to the NAV. Little impact is likely from this element.

The premium or discount to NAV – as a heavy issuer of equity, the prevailing premium or discount of the new shares to book value will impact the post-issue NAV: issuing at a premium boosts, and at a discount erodes, the NAV. The share price has generally been above NAV since IPO and some share issues have bumped up the NAV: the February 2019 share issue, for example bumped the NAV up by 1.2 per cent because of the share price premium. Both of the 2021 equity issues were comfortably above NAV.

Energy yield - asset valuations assume that a turbine produces electricity 90 per cent of the time (known as P90/P10). Every 1 percentage swing away from the 90 per cent assumption hits the NAV by 10p and in 2021 this will have been negative but the impact is limited by a long-term smoothing effect.

Government subsidy – around half of the group's revenue is, in effect, from government subsidies that are in place to allow offshore producers to stabilise prices. This has been placed under-review for larger schemes with the threat to lower or remove subsidies unless more of the supply chain for new developments resides in the UK. This and other changes to subsidies could impact profits, cash flow, dividends and NAV growth.

An index-linked dividend

UKW's dividend policy is to grow the annual payment by RPI (retail price index inflation) as long as this does not have a negative impact on the NAV. This has meant that the dividend has been steadily increasing and on the forecast 7.2p for FY2021, the yield is around 5.2 per cent. The current high rate of inflation could be more testing this year and next for the indexation of the dividend. There are a lot of moving parts to movements in the NAV and while these should be net favourable, it is possible that due to the smaller relative contribution from retained profit, the NAV may not rise by an amount equal to the 2020 dividend plus RPI (which could be as high as 6 per cent).

Last year's dividend was 7.1p and an RPI increase would be around 7.5p, but consensus forecasts for the dividend is 7.2p and only rising to 7.8p by 2023; so forecasts already seem to assume that there will be no indexation in the near-term. This would still represent a good level of income and there is little doubt that these levels can be paid out from cash flow but the notion of a dividend that grows consistently in real terms is likely to have been lost. This could become an issue for some investors but the yield is still materially above the market average of 3.4 per cent.

Surprising ESG score

One might expect a high ESG score from a business 100 per cent focussed on clean energy. However, Refinitiv only gives UKW a score of 32/100 primarily because of a very low score on governance (6/100).

Conclusion

One might have assumed two key reasons for investing in this investment trust: strong ESG credentials and an indexed dividend. On ESG, while environmental credentials are strong the picture is not complete and lower than expected ESG scores are not uncommon in this space. In the peer group, Foresight Solar and John Laing Infrastructure fare equally poorly, Next Solar is a little better and only Renewables Infrastructure fares well with a score of 78/100 (but this is owned by private equity).

An indexed dividend is more easily delivered in a sustained low inflation environment, but becomes more of a burden when consumer prices start to soar. This could become a problem for some investors looking at this fund, especially when coupled with the yield ranking lower than other funds: yields in the peer group range from 6.6 to 7.2 per cent. That said, UKW has much better earnings cover but there is no broad expectation that these other funds are likely to cut their payments so the gap is likely to remain.

This fund might tick a lot of boxes for more ethical and green investing but that is only fully of merit if the fund is also likely to make good returns. A 5 per cent baseline from the yield is okay, but investors need to be confident that NAV growth will come through and in this fund that is difficult to determine externally. Higher energy pricing, the decision not to fix price but float the majority of contracts and higher inflation are positives but 2021's issue with the energy yield, more expensive borrowing and higher discount rates will pull some of that back. Then there is the issue of whether investment trusts generally and green funds more specifically can hold their current share price levels relative to NAV. Wind is popular today but could lose out to alternatives in green energy.

On balance, it is likely that the positives will outweigh the negatives here and that total returns can stay ahead of inflation, but perhaps only just. The reason we looked at this company is because it was flagged by our Alpha screen focussed on GARP (growth at a reasonable price), but while this stock might look cheap on a PE basis (c.7 times next full year earnings) the valuation here is led by the NAV and the computation of that is far from simple and is somewhat opaque. Buying this stock because the PE and yield are: a) close together which can be a powerful lure and, b) are at attractive levels, might lead investors astray.

Alpha Editor: James Norrington
Alpha Production Editor: Sameera Hai Baig

ISSN 0261-3115.