EDISON

SDCL Energy Efficiency Income Trust

Answering five key investor questions

Investment trusts
Renewable energy infrastructure

10 June 2024

Price	**68.2p**
Market cap	**£745m**
AUM	**£1,006m**

NAV/share*	90.6p
Discount to NAV	25.7%

*Including income. As at 30 September 2023.

Yield	9.15%
Ordinary shares in issue	1,093m
Code/ISN	SEIT/GB00BGHVZM47
Primary exchange	LSE
AIC sector	Renewable Energy Infrastructure

52-week high/low	90.2p	51.8p
NAV** high/low	106.1p	95.6p

**Including income.

Gearing

Structural*	34%
Total*	44%

*Of NAV. As at 30 September 2023.

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In this note we examine five key questions investors have raised regarding SDCL Energy Efficiency Income Trust (SEEIT), prior to the release of its full-year results (for the year ended March 2024) at the end of June 2024 and provide our answers and analysis. The questions focus on dividend security, discount to NAV, management's strategies for closing the discount, asset valuations and where SEEIT differs to its peers. SEEIT is an investment trust focused on delivering energy and energy efficiency as a decentralised service directly to end users, rather than supplying into the broader power grid. Its income comes from a range of services and is driven by cutting losses in energy generation, transmission and use. SEEIT offers an attractive dividend yield (9.15%) and upside from narrowing of the discount (c 26% or c 35% upside if closed).

Questions investors are asking

SEEIT, like many of its peers in the listed renewable energy infrastructure space, raises a set of common questions from existing and potential shareholders. Some of this curiosity is driven by the size of the discount to NAV, and the apparent investment opportunity. At a c 26% discount to NAV, this presents substantial upside to an investment if this discount were to close. We examine what could make this discount narrow and, therefore, build investors' confidence.

There are five key questions:

1. Are SEEIT's assets worth more in the private market?
2. Can the dividend be maintained?
3. Why is the discount to NAV so large?
4. Why did SEEIT write down the value of its largest asset?
5. How does SEEIT differ to its peers?

Our view

We provide our views on how these questions can best be addressed. Naturally, there are not always simple answers but we believe the difference between private and public market valuations is that the core underlying assumption (by the public market) might be wrong. If SEEIT, and renewable energy trusts more generally, can recycle capital at discounts less (or much less) than the implied market discount and use this capital to buy back stock, increase dividend cover or pursue higher return growth, it is a value accretive strategy, in our view.

Aside from this broader sector issue, SEEIT's discount (relative to its peer group) looks unjustified in our view given its scale, dividend coverage and a diverse and differentiated revenue model.

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Five key questions

We have based this note on the questions raised by some investors during our investor outreach and via email. This is a subset of a longer list and we have prioritised the most commonly recurring queries. The answers provided in this note are our own and based on our opinion, rather than management guidance, and we welcome any direct feedback.

For a full detailed overview of SEEIT, including a description of its asset portfolio, please see our initiation note.

Are SEEIT's asset worth more in the private market?

It is possible that SEEIT's assets could be worth more in the private market, further supporting the significant undervaluation in the current stock price. This is a major issue across both the listed investment trust and private equity market. Listed investment trusts have raised their discount rates in response to the rise in interest rates globally. SEEIT now stands at an 8.7% weighted average unlevered discount rate (March 2023: 7.7%) and 9.4% levered (March 2023: 8.5%) at 30 September 2023. The weighted average discount rate was 7.5% three years ago.

The implied discount rate the market is applying to the assets is in the order of 10–12%. This seems excessively high for assets with long-dated and relatively secure income streams. If SEEIT can recycle capital through the sale of more mature, derisked assets with valuations closer to their NAV carrying value, or even at a premium (which has been seen in relation to solar assets recently) to the discount to NAV assumed by the market, this highlights a strong signal of mispricing. SEEIT can then use this capital generated to further reduce short-term debt, explore accretive expansions on existing assets or more strongly build out its dividend cover, which are all positive signs in our view.

Like any public company, the potential for assets sales is opaque but, in its interim results (to 30 September 2023), SEEIT stated that it is 'actively pursuing options to realise liquidity for the company through selective asset disposals' and 'progressing selective disposals to bolster the balance sheet'. CEO Jonathan Maxwell indicated he has received 'a number of credible proposals in relation to multiple assets that are within its range of pricing expectations and thereby support the most recently published NAV'.

Since its interim results, SEEIT has added further traction to the argument that its assets are worth more in the private market than the public market with the announcement on 7 May 2024 of the sale of its 69MW UK on-site solar portfolio, UU Solar (9% of SEEIT's NAV as at 30 September 2023), to UK Power Networks Service Holdings Limited for a total consideration of £90.8m. The sale represented a 4.5% premium to SEEIT's carrying valuation of UU Solar as at 30 September 2023. The proceeds from the sale will be used to reduce its short-term borrowings via the company's revolving credit facility (RCF), which was £155m drawn at March 2024. The sale of UU Solar is therefore a primary example of how SEEIT can create further liquidity and capital allocation options, allowing it to strengthen its balance sheet and recycle capital into its proprietary/organic pipeline and existing investments to generate higher returns. The announcement also stated that strengthening the balance sheet remains a key focus for SEEIT, and good progress is being made with further asset disposals and co-investment partnership opportunities, as referenced in its interim update statement on 19 March 2024.

Other emerging signs of the disconnect between private and market valuations came to light throughout 2023 and at the beginning of 2024. For example, in November 2023, Foresight Solar

Fund sold 50% of its 99MW Lorca portfolio in Spain for €26.9m, which was at a 21% premium to its Q3 holding value. Additionally, in August 2023, The Renewable Infrastructure Group (TRIG) exchanged contracts to sell three wind farms in the Republic of Ireland for a combined consideration of c €25m to Statkraft. This was at a 26% premium to TRIG's valuation at 31 December 2022.

Can the dividend be maintained?

In our view, maintaining the dividend seems very likely. Dividend security can never be guaranteed for any public equity, but based on current data, we do not believe there is any particular reason why SEEIT would be looking to cut its dividend, especially as its income and asset stream is relatively diverse and its refinancing risk appears low. At H123 (ended 30 September 2023), the dividend cover was 1.1x (ie 1.1x covered by cash generated by the portfolio) and management stated it expects this to grow by the end of 2024 and over the medium term. In its interim update statement (published 19 March 2024) management highlighted that SEEIT is on target to deliver a fully covered aggregate dividend of 6.24p for FY24 (ended 31 March 2024). Although never certain, we emphasise the following factors in favour of relative dividend security:

1. **SEEIT's exposure to public energy markets is relatively low.** Power markets (and energy commodities) have been volatile and trending negatively over the past year, which has also had flow-on effects to less visible markets. For example, there was an interruption to the battery energy storage market in the UK, which was caused by using cheap gas-fired generation as swing power. This is a useful contrast to SEEIT's market risk as the company's ultimate revenue sources are, generally, not linked to public markets but instead are direct fees paid by end users for providing energy and energy-related services.
2. **SEEIT's counterparty risk is relatively low.** Over 60% of the portfolio is associated with investment-grade or equivalent counterparties.
3. **SEEIT's gearing is reasonable.** The company's portfolio-level gearing at 30 September 2023 was 34% of NAV (structural), with an aggregate gearing of 44% (total). This is generally lower than a number of its peers as they report gearing relative to GAV. Therefore, when converted to on a NAV basis, they become much higher. For example, the average gearing across five of its peers (Aquila European Renewables, Octopus Renewables Infrastructure Trust, Ecofin US Renewables Infrastructure, US Solar Fund and JLEN Environmental Assets Group on a NAV basis is 55%. The weighted average life remaining on SEEIT's debt is four years, with a weighted average interest rate of 5.7%. The fixed interest rate exposure of the drawn portfolio is 85%. While debt structures within trusts can be complex, there does not appear to be a refinancing risk that would rapidly change the cash required for debt servicing. Management expects its revolving credit facility (RCF) to be c £155m drawn at 31 March 2024, with this amount reducing in the near term as proceeds from any disposals are used to pay down the RCF. Management also forecasts the aggregate borrowings by its portfolio investments, excluding the RCF, to be roughly £325m at 31 March 2024 (vs £334m at 30 September 2023).

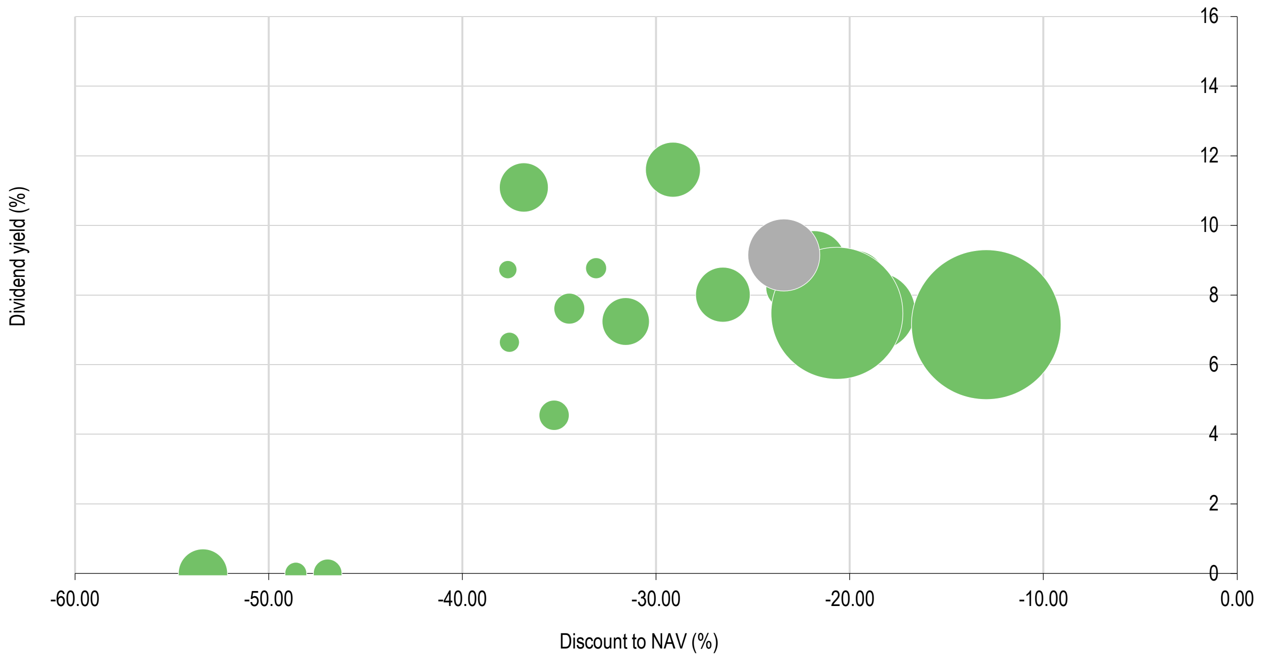
Why is the discount to NAV so large?

There are two parts to answering why the discount to NAV is so large. Firstly, why do discounts to NAVs exist across the renewable energy infrastructure sector? Secondly, why is SEEIT's so large?

We have addressed the reasons why discounts to NAVs exist in the renewable energy investment trust sector in our note on Premier Miton Global Renewables Trust as it is a common query. In summary, in our view, the market has treated much of the sector as bond proxies, derating the stocks as interest rates have risen. Where the market was content to hold these stocks at 4–5%

dividend yields and where these are achievable through risk-free gilt or money market funds, the sector has needed to shift to 8–10% fields to attract marginal investors. It is possible to argue (and we have) that many investment trusts are able to organically growth their NAVs and, therefore, should be considered more highly rated than bonds. However, this is not widely considered by investors, in our view, and the inherent risks in some underlying businesses remain a key concern. We have also argued that the sector has been somewhat a victim of fund flows and a stabilisation of rates (rather than a full reversal) might be sufficient to drive some investor interest back more broadly into the sector.

Exhibit 1: Discount to NAV and dividend yield of listed renewable energy investment trusts



Source: Morningstar at 6 June 2024. Note: Size of bubble equates to market capitalisation and grey bubble represents SEEIT.

The second part of our question is whether SEEIT's discount to NAV is relatively large compared to its peers. With the discount to NAV of 26%, compared with the sector weighted average of 23% (as at 6 June 2024), the data suggest that it is. However, this is unusual as SEEIT's discount is large despite its relative size, and the other funds closer to SEEIT's discount are either smaller in size or more focused. This relative discount is therefore unjustified in our view. The market seems to be treating SEEIT as subscale (which it clearly is not) or potentially as a trust with a relatively risky underlying asset base, which seems unjustified (see points 1 and 2 in the question above).

How will management address the discount to NAV?

Like other management teams in the investment trust sector, we believe SEEIT's management team is deeply concerned about the discount. The sale of UU Solar further emphasises that SEEIT is undervalued and that there is a clear disconnect between public and private market valuations, as SEEIT is still trading well below NAV despite as UU Solar being sold at a 4.5% premium to SEEIT's carrying valuation at 30 September 2023. There are several steps, both major and minor, SEEIT is undertaking to help close this gap, including:

1. **Emphasising the security of revenue streams.** This is related to the issue of dividend security, dividend coverage and the nature of SEEIT's business (see our answer to SEEIT's dividend question).
2. **Continued organic investment into SEEIT's portfolio to add further accretive value.** During the period between 31 October 2023 and 18 March 2024, SEEIT made organic investment (totalling £52m) into its existing portfolio of under development or construction

investments. This was primarily in Red Rochester via the continued progress of a combined heat and power (CHP) co-generation plant, which (when operational in 2025) will improve margins and cash flow generation, and Onyx, where SEEIT expects a strong double-digit internal rate of returns. An overview of other potential value accretive opportunities for Onyx (as stated by management) can be seen below.

Exhibit 2: Additional value accretion potential given by SEEIT for Onyx

Action	Estimated potential value uplift	Time period
A 10% increase in expected annual MW deployment in 2024 and 2025 would accelerate the receipt of cashflows for the 100% owned portfolio	£5–10m	3 years
The value of the Onyx development platform assumed a level of MW of projects developed per year and any increase in MW would increase the value of the platform	£5–10m	Over 3 years
Improved economics with the Inflation Reduction Act. This benefits the Onyx development platform as it improves the economics of any assets sales	£2–5m	3–5 years

Source: SEEIT's annual results to 31 March 2023

3. **Buying back stock.** Another clear signal that the discount looks large is the fact SEEIT announced its share buyback programme on 3 April 2023 and completed the programme as at 30 September 2023. The programme was funded by surplus liquidity and operating cash flow from the portfolio with a total allocation of up to £20m from its available cash reserves. The full £20m was utilised throughout the programme. Management has not stated any intention for any future buyback programmes.

Why did SEEIT write down the value of its largest asset?

SEEIT's largest single asset is the Red Rocester (RED) district energy system, which is the exclusive provider of 16 on-site energy efficient services to customers within the Eastman Business park in the US, at which it has contractual and regulated utility-status franchise rights (see our initiation note for full details). Red Rocester accounts for 16% of SEEIT's portfolio and its carrying value was written down from £254m at FY22 to £180m at H123. The issues at Red Rochester appear to be due principally to a lack of capacity utilisation and this was being conservatively reflected in its valuation. The main concerns are:

1. **Fluctuations in demand.** A downturn in demand for Red Rochester's customer products resulted in a reduction of the energy supplied by SEEIT. This was due to unusually mild weather conditions and revisions to business plans for a few of Eastman Business park's tenants, resulting in a downward valuation to reflect the increased risk. The park's management team, however, continues to proactively attract new customers, more than doubling its pipeline during its H123 period, to increase future revenue security. Despite year-on-year EBITDA growth, management expect the full year loads and EBITDA to be below budget.
2. **Client's construction pause.** SEEIT made a downward valuation adjustment of c £11m, reflecting the uncertainty over Li-Cycle's (one of RED's largest customers) future energy demand in light of its construction pause. SEEIT expects Li-Cycle construction will continue but it has reflected the unpredictability in its valuation.
3. **Review of the project financial model.** SEEIT and the RED management team conducted an additional in-depth review of actual results and how certain long-term assumptions were applied in the project's financial model. Several revenue and cost estimates have since been revised (up and down), resulting in an overall valuation reduction of c £26m.
4. **Updated assumptions.** A combination of updates to projected loads, business development assumptions, operating costs, labour costs and timing of new efficiency projects have also caused a reduction in the overall valuation of c £17m.

In our view, this looks like a comprehensive review of valuation assumptions, with some conservatism built into each. On 19 March 2024, SEEIT stated that the building of the CHP co-generation plant at Red Rochester was progressing as expected and that it will add to margins and cash flow in 2025.

How is SEEIT different to its peers?

SEEIT stands out compared to the other listed renewable energy infrastructure investment trusts in its AIC peer group because:

- It has greater US exposure than the majority of its peers (56% as at 30 September 2023).
- It has a differentiated revenue model, in which SEEIT's assets are directly connected to the end-user. Hence the majority of SEEIT's assets are classified as on-site assets and this proximity and direct connection (decentralised service) cuts out the need for an intermediary (ie the broader power grid). Through this model, revenue is secured under long-term contractual arrangements and driven by reducing losses in energy generation and use.
- It has a more diverse portfolio of technology exposure (>11 different technologies), with its largest two weightings being solar and storage (24%) and district energy (16%).
- It can squeeze additional improvements out of its assets through continued investments, creating value accretive potential (ie organic investment/improvements).

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