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http://www.ftseglobalmarkets.com/index.php?option=com_k2&view=item&id=3328:what-is-driving-value-in-the-energy-efficiency-sector-today

What is driving value in the energy efficiency sector today?

Two energy efficiency deals were amongst the largest Cleantech deals completed in Europe in 2011. Schneider Electric purchased Telvent for $1.4bn and Toshiba purchased Landis+Gyr AG for $2.3bn. The total value of energy efficiency deals in 2011 was more than twice that in 2010. This is a trend that is expected to continue as corporates and governments together come to better understand the demand side of energy and the opportunity inherent to meet their target of a 34% reduction in greenhouse gas emissions by 2020 against a 1990 baseline.

Despite some bumper deals, it has not been all plain sailing for the Cleantech sector. As at March 2012, the WilderHill Clean Energy Index (ECO) is down 27% over the past 3 years versus the NASDAQ Composite Index being up by 102% over the same period. However, in Q4 2011, of the top 5 performers in ECO, two were energy efficiency companies (Ameresco rising 35% and AO Smith rising 25% over the quarter). The energy efficiency and storage sub sector was the best performing within the index.

For investors, the asset class may provide an opportunity based on certain broad fundamentals. Energy costs are expected to continue to rise over the coming years and we are likely to be in the second half of a world recession which should bode well for energy service solution companies targeting energy intensive corporates; especially those that face tight margins. Many of these corporates may begin to be in stronger positions to make bold strategic decisions around their energy strategies like Tescos and Morrisons have done.

Furthermore, of the buildings that will exist in 2035, 90% exist today. The retrofit opportunity is one of the greatest opportunities we have today. In the US, banks such as Citigroup and Bank of America have allocated funds towards efficiency projects as has the European Commission through its recently launched European Energy Efficiency Facility. For the financial sector, this is an attractive investment opportunity as energy savings can be typically underwritten via energy performance contracting. The assets are particularly low risk and are long-term in nature, making them attractive for pension funds, life-insurance companies and sovereign wealth funds that are looking for assets to match their long term liabilities. A bonus for equity investors is that the payback periods can be three years; with simple lighting upgrades delivering IRRs of nearly 20%.

So you may ask why aren't more CEOs and CFOs investing in energy efficiency projects? Part of the answer lies in the fact that energy costs still represent a relatively small portion of corporate operating expenditure. On average for a FTSE 100 company, total energy spend is approximately 2% of revenue. However, with average net income margin being approximately 16%, reducing these costs by even 25% translates straight to the bottom line, which can be material for many FTSE 100 companies. In many of the discussions we are having, corporate minds are increasingly being focussed by the risks and opportunities associated with commodity and energy prices, regulatory changes and corporate reputation.

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