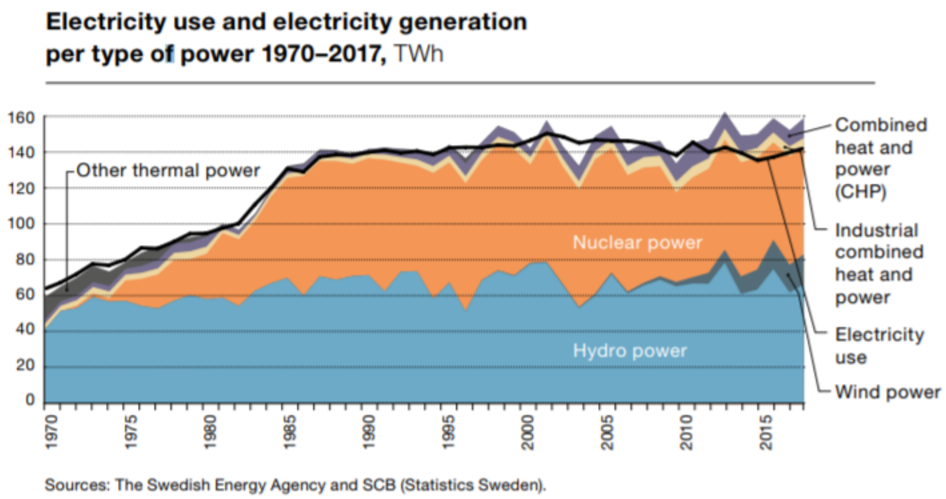
EOLUS VIND – TAILWINDS

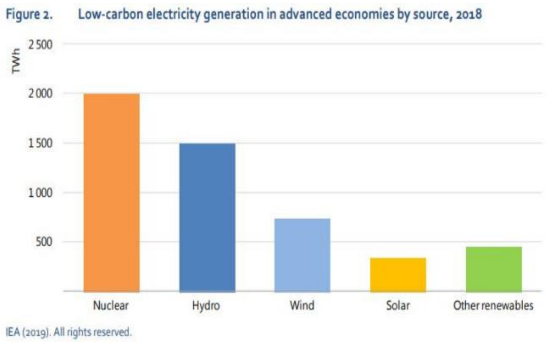
Although the term ESG, coined by Ivo Knoepfel in his 2005 study «Who Cares Wins», has been around for many years already, with capital starting to flow into the theme in earnest in 2013/14 following academic studies proving ESG principles enhances returns, it only began emerging on everybodys lips a couple of years ago.

As fund managers are scrambling to greenwash their portfolios amidst the implementation of ESG investing across the industry, value investors risk getting squeezed out of the theme as the indiscriminate buying keeps pushing valuations into uncharted territory. As much as $20trn are estimated to be following these principles globally now.

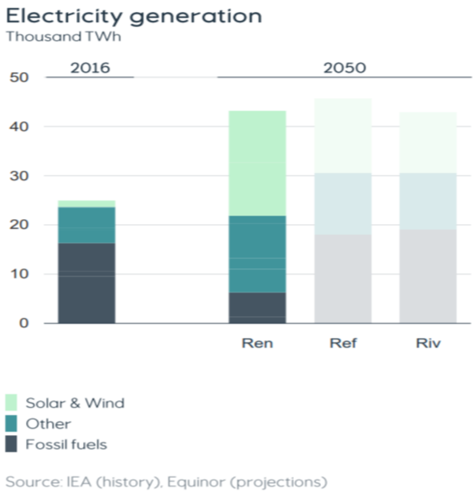
Sustainable investing doesn`t have to mean accepting unsustainable valuations, though. Eolus Vind is a charming case in point.



Driving through a.o Denmark and Sweden these days, one just can`t help noticing the emergence of windfarms everywhere. By 2018 approximately 13pc of Sweden`s electricity production came from wind, 40pc from hydropower and 38pc from nuclear. In 2021 the production from wind looks set to grab more than a 20pc share. As Sweden targets zero contribution from nuclear by 2040, the market for wind farms looks set to boom over the next couple of decades as hydropower has reached it`s limit and other sources of energy are not competitive. On that note; you can build 3 MWH of onshore wind for the cost of every MWh of nuclear in Sweden today. Wind is competitive, and is no longer reliant on subsidies. That bodes well for investor appetite for these projects going forward. IEA in it`s latest World Energy Outlook highlights similar trends globally,



while Equinor sees a massive wave of investments in renewables in electricity generation over the next 30 years.



Emerging as Sweden`s first commercial wind farm developer in 1990, Eolus has built 544 of the 3500 or so turbines currently operating in Sweden. The idea is to develop turnkey wind farms to outside investors, offering management and services of these farms as well.

The track record has been solid, with no projects delivered at a loss as far back as I can see, and no project delivered at less than a 5pc EBIT margin for at least the last 6 years. Given Eolus` track record I am surprised to find this unrecognized by the market. The only explanation I can see (other than it`s small cap status) is the optically high variation in the company`s results historically giving investors a hard time forecasting future results with any certainty. There are mainly 2 reasons for this

1) The company has booked projects when delivered, resulting in lumpy earnings and balance sheet metrics as shown below.
2) The company has previously chosen to own some of the windfarms themselves, resulting in a P&L dependent on fluctuating electricity prices.

Eolus Vind	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
REVENUES	156	304	440	731	1408	1628	1887	1204	466	1502	693	1065	1366
EBIT	7	36	65	65	143	211	81	146	41	90	-16	40	202
EBIT%	**4,5 %**	**11,8 %**	**14,8 %**	**8,9 %**	**10,2 %**	**13,0 %**	**4,3 %**	**12,1 %**	**8,8 %**	**6,0 %**	**-2,3 %**	**3,8 %**	**14,8 %**
NET PROFIT	6	24	52	51	99	151	28	141	10	80	-23,9	24,5	194
EPS	0,57	1,95	2,9	2,8	4,6	6,71	1,24	5,75	0,4	3,3	-0,92	1,02	7,8
No of inst	15	26	26	29	54	50	81	30	27	33	14	25	25
`-in MW	16	29	32	48	97	100	155	62	53	69	38	72	84
MW/inst	**1,07**	**1,12**	**1,23**	**1,66**	**1,80**	**2,00**	**1,91**	**2,07**	**1,96**	**2,09**	**2,71**	**2,88**	**3,36**
Rev/MW	**9,75**	**10,48**	**13,75**	**15,23**	**14,52**	**16,28**	**12,17**	**19,42**	**8,79**	**21,77**	**18,24**	**14,79**	**16,26**
EBIT/MW	**0,44**	**1,24**	**2,03**	**1,35**	**1,47**	**2,11**	**0,52**	**2,35**	**0,77**	**1,30**	**-0,42**	**0,56**	**2,40**
EBIT/inst	0,47	1,38	2,50	2,24	2,65	4,22	1,00	4,87	1,52	2,73	-1,14	1,60	8,08
EPS/inst	0,04	0,08	0,11	0,10	0,09	0,13	0,02	0,19	0,01	0,10	-0,07	0,04	0,31
EPS/MW	0,04	0,07	0,09	0,06	0,05	0,07	0,01	0,09	0,01	0,05	-0,02	0,01	0,09

Source: Company annual reports

Starting a few years back, the company decided to scale back on owning farms as a means to free up capital, and only 1pc of the company`s revenues came from electricity generation last year. With 98pc of revenues now derived from new projects, the company should be evaluated on their track here.

Valuation

Adopting IFRS 15 as of the current fiscal year implies a smoother and more stable P&L from year to year, and there are reasons to think this change to percentage of completion will increase investors' confidence in what to expect in terms of future earnings. As of the current quarter, the company has a project portfolio of SEK 8bn under construction, to be delivered through 2021. Booking this under IFRS 15 means quarterly numbers approx as follows for the next 11 qtr`s (increasing towards the end of the period):

SEKm	**PR QTR**
Revenues	750
EBIT%	10 %
SGA	-17
net finance	-3
Pretax	55
Net	**43**
EPS	**1,72**
FCO	**50**

SEKm	
Fixed assets	133
Current assets	1575
`-of which cash	362
LT debt	191
St debt	719
Equity	798
Net working cap	**856**

The 10pc EBIT margin ought to be conservative. There are reasons to believe the company plans for closer to 15pc margins on it`s closed book projects, with write-offs of projects halted in the pre-construction phase diminishing as a % of the total as the delivered projects grow larger. Also, the previous table shows that the MW/inst has tripled over the last 12 years while revenues/MW seems to have stabilised around SEK 15-20m, leveraging Eolus` organisation as projects grow larger. With SEK 8bn to be delivered over the period annual revenues look to go up more than 50-100pc over the last delivery cycle peaks. 12pc EBIT means 55m net/qtr, or EPS of 8,8 pa, highlighting the leverage in Eolus` organisation. I have used a conservative 22pc tax rate on this, in reality this ought to be lower depending on how projects are structured when sold.

The capital light nature of its business makes for an attractive cash conversion as projects are delivered. With 92pc of its assets being current and 2/3 of that again in cash and inventories, understanding the project cycle cash flow is key. Typically, 70pc of the cost of any project enter Eolus` books in the last 6 mths before delivery. Eolus keeps a large amount of cash to deal with this, currently around SEK 360m on SEK 850m in net working capital that will be released as projects are delivered. In addition, based on the above, the company will add another approx SEK 550-650m in FCO through the period ending in 2021, implying net cash of >SEK 1400m on this SEK 1700m mrk cap company when all the projects have been delivered by the end of the period, leaving investors to pay SEK 300m or SEK 12/shr for a business with a solid track record and proven ability to generate > SEK 6,8/shr in EPS annually.

How much of the SEK 56/shr in net cash by YE 2021 will actually be paid out remains uncertain. Eolus`mgmt seems conservative on this issue (as well), indicating a preference to maintain a high level of cash in order to handle increased project volumes. I don`t really see why it can`t bridge finance more of the last few months of construction, and will bring this up again in future discussions, as the bulk of the cash outlay happens during the last 6 mths before delivery. For now, I assume the company will maintain approx SEK 600m in net cash to handle future business, allowing approx SEK 800m or SEK 32/shr to have been paid out by the end of 2021. Using a 10pc discount rate, that means a P/E of 6,8 on a maintained activity level after 2021. Importantly, by paying out a SEK 10 eo divi in 2015, the BoD proved it is willing and able to pay out excess cash to shareholders as delivery cycles peak.

That is just too cheap to ignore. >20x seems more appropriate given the capital light, high cash-conversion nature of its business. Add the minimum SEK 32 in excess cash to it and a 10pc discount rate and you end up with SEK 170 as a fair target, implying a 6pc free cash yield on today's run-rate revenues and a 10pc margin, and earnings multiples still equivalent to the revenue multiples on most of the popular mainstream «ESG-stocks».

Maybe, eventually, when the hype begins to fade, some adults in the ESG-room will add «sustainable valuations» to the sustainable investing theme? If so, Eolus will warrant scrutiny by many more investors going forward.

Dirty & clean seen side by side on a recent trip to Denmark

Oslo, 16062019

Ståle