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## Full throttle

Vanessa Drucker

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Soaring oil and energy prices ignited a global focus on alternative energy and hard-nosed investors are reaping the rewards of a surge in green technology, writes Vanessa Drucker, Fund Strategy's American editor in New York.

The old guard is wary of the new generation, even in the idealistic pastures of green investing. In California, still the epicentre of the movement in America, rivalries are emerging. The vanguard of the industry, who were already installing solar panels in the 1970s, is losing ground to the younger, more progressive businesses of today.

Solar City, which is the leading solar installer in California, was launched from scratch in 2006, by two internet entrepreneur brothers. "Other companies, which had been around for years, watched Solar City run right by them," notes Benjamin Black, of New Cycle Management, a venture capital fund.

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Thus the dynamics are shifting across the industry. The days of well-intentioned tree-huggers and socially responsible funds are making way for new ranks of profit-orientated, hardnosed, commercially minded investors. "I didn't start my firm to change the world, or to do good, and we don't do missionary selling," says Brian Greenstein, managing partner of Ardour Capital Investments, which operates the longest running alternative energy conference each year. "We're thrilled to be capitalists in an important sector."

While many operations are focused on offering environmental benefits, the investment category has assumed another facet. Fund managers are taking a wider universe of firms for their starting point, and grading them according to the degree of benefit they derive from their ecological stance.

Socially responsible investing has a long history. It initially constructed its mandate around screening out "sin" activities, such as tobacco, firearms, gambling, alcohol, violent entertainment and other "Quaker" issues. As a subsector, the investment style included alternative clean energy themes among like-minded enthusiasts. A decade ago, only about 250 companies worldwide comprised the green universe. Today, that number has swelled to more than 1,000.

While consciousness was already burgeoning in Europe, there was no corresponding interest in America. Since about 2002, alternative energy has become a gold rush there too, attracting capital, talent and attention. Companies have developed technologies to address compelling problems, although many still lack a value proposition for making money.

Funds have broadened out as well, so that a host of mainstream vehicles are making allocations to alternative energy. For instance, managers running traditional oil and gas funds are putting clean tech money to work as a subcategory.

Even high-flying professionals are betting their careers that the sustainability movement will endure. Meanwhile, the quality of entrepreneurial capital has risen, with high calibre firms like Kleiner Perkins betting the house on the trend.

That venture capital firm announced at the end of April that it has raised \$500m (£255m) for a fund focused on large companies with green operations, which will increase its total green investment level to \$1.2 billion. Generation Investment Management, a London firm co-founded by Al Gore, is contributing a large portion of the new money to Kleiner.

Simultaneously, Kohlberg Kravis Roberts is announcing the launch of its "Green Portfolio" programme, which will develop a methodology to measure the environmental progress of its American company holdings.

In corporations, a vice president of environmental affairs has become an in-house standard, as a ranking executive position for integrating environmental issues with overall strategy. General Electric instituted the practice in the early 1990s, followed shortly by International Paper and big chemical companies. "In the past year, even MBA programs have begun to focus on training students in green," reports Deborah Marshall, an attorney with Howard Rice in San Francisco.

What has encouraged this quickening of interest in America? The most recent driver is the recognition of energy needs. The price of oil has doubled over the past year, against an incessant drumbeat of warnings: an emerging consumer class can barely satisfy its demand for fossil fuels. At the same time, oil has become more than ever a security issue. Black says: "Imagine that, instead of spending \$3 trillion in Iraq, we had invested that money in renewable energy." A few months after Operation Desert Storm began, in August 2003, the largest blackout ever in America affected 50m people in America and Canada. The vulnerabilities of the electrical grid reawakened consciousness in alternative energy sources.

As the demands for electricity and power usage rose rapidly around the world, a need was crying out for a solution. Consumers, in their own homes, were steadily increasing their energy requirements, with multiple appliances, computers and televisions. "The development of solar was a tipping point, as people realised the panels could be produced," says Greenstein. "That is the beauty of capitalism. Although technologies may be somewhat disruptive, when they are presented in an economically viable fashion, they do get adopted."

In Europe, an equally important driver is that of the ethical consumer, says Charlie Thomas, manager of the Jupiter Ecology fund. He reports that over the past 15 years, various marketing metrics have pointed to a fairly static level of behaviour, which has accelerated in the past 18 months. The statistics are based on such variables as media awareness, concern for climate change and water pollution, and the growth of organic food.

Politicians take note, and recognise that clean energy ticks every box in the world and appeals to their populations as a vote winner. Every government believes in it, or at least, pays lip service. "Even if the supposed pattern of global warming turns out not to be true after all, the green motif touches the zeitgeist of the times," comments Jim Mellon, co-author of "The Top 10 Investments for the Next 10 Years."

Underpinning all the drivers, legislation has always been a potent force behind environmental investing and capital flows. "While the EU has been adopting environmental legislation since the 1960s, in the past five years regulation has broadened out globally. China and India will soon see the next wave, which will arrive in fits and starts," Thomas predicts. As the two

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countries create infrastructure, it seeks to mitigate the headwinds suffered in the form of water and air pollution. Since 2004, pollutants may have reined in Chinese GDP by as much as 3.5%, according to Thomas.

Regulation in America has mapped out a different trajectory. The American environmental justice movement was already germinating in the early 1990s. This groundswell derived from reports issued in the late 1980s by the Environmental Protection Agency (EPA), which showed that low income people tended to live closer to toxic sites and chemical plants. "They came out with empirical data, which wasn't anecdotal," explains Gail Suchman, an environmental attorney with Stroock & Stroock & Lavan in New York.

In 1991, leaders from the civil rights movement attended a big conference in Washington DC, where they concluded that environmental protection was itself a civil right. The groups found a friend in Bill Clinton, whose administration prompted the EPA to build some momentum among large corporations. "What started as a grass roots organisation expanded from the bottom up, and eventually gave voice to powerful proponents," Suchman says.

The industries that have evolved from early days cover a wide spectrum of environment-related activities. Thomas outlines a handful of the multiple themes his fund follows across the sector, highlighting clean energy, insulation and energy efficiency; water, wind power and solar panels; waste management, including recycling; transport, involving energy efficient vehicles, emissions and public transport; sustainable farming and organic foods.

The main alternative energy technologies are nuclear, wind and solar. Nuclear still arouses suspicion, especially regarding the waste disposal problem. Wind power, of which about 50% gets leaked, reaches a threshold of efficiency at a certain limited level. Solar, on the other hand "is the real thing", proclaims Mellon. "It will be bigger than the internet." Hitherto, a worldwide shortage of raw polysilicon, a key element of photovoltaic cells, has reined in production. Now, firms like First Solar are using cadmium telluride, another semiconductor that absorbs more sunlight. A new generation of thinner solar film can replace the silicone materials more cheaply. Mellon suggests that solar panels will rapidly follow the sequence of Moore's Law, falling in price by 50% every 18 months or so.

More tracking indices and rating systems have been designed to measure sustainability in corporations. Innovest Strategic Value Advisors was one of the earliest, dating back to 1995. It followed a philosophy of identifying non-traditional sources of risk and value, including environmental aspects. Standard & Poor's looks at potential carbon emissions and factors that into its ratings analysis. A handful of major banks including Credit Suisse, JP Morgan and Citigroup, have begun to assess carbon risks in making lending decisions, according to Suchman.

Those businesses that strive for a positive social impact may derive a competitive business advantage from that mission itself. For example, they may be capable of attracting exceptional talent from top executives, and also inspiring employees throughout the ranks.

The demarcations easily blur, however. "Though most social funds try to present themselves as 100% pure, not everyone agrees," points out Brent Kessel, co-founder of Abacus Wealth Partners, a financial planning firm involved in sustainable investing. Take the controversies over nuclear power, which produces most French electricity. "Yet France is the cleanest industrialised country on the planet," Kessel says. In America, few plays exist. The largest solar manufacturer, BP Solar, is a subsidiary of British Petroleum, while FPL, a nuclear utility, is the leading generator of wind. Duke Energy, a heavy coal burner, "has been lionised for favouring carbon caps," says Jonathan Naimon, chief executive officer of Seattle-based Light Green Advisors.

Rafael Coven, managing partner of Cleantech Indices, runs an index created in 2006 to track the success of clean technology businesses. "We need technology-based tools, to raise productivity, while reducing resource consumption and negative impacts on the environment and public health. If we wait for every company to behave perfectly, the game is over," Coven says. He looks at several factors, such as market capitalisation, industry position, strategy, profitability, intellectual property, sector coverage, management quality and innovation. "All companies must derive at least half their revenues from clean tech operations, which would automatically exclude, say, General Electric," Coven explains. He also steers clear of any commodity product, on the principle that price competition will erode profits.

Kessel's approach avoids industry exclusion. "When you wipe out energy or tobacco, you get rid of entire sectors, which leads to tracking error," he notes. Instead, he measures each company against its own industry peers, rather than the entire market. That may mean rewarding the cleanest energy or chemical companies, relative to peers, even if the business is still not as clean as software or a bank. Consider a sector like auto manufacturing. "Should we exclude Ford or Toyota?" Kessel asks. It is true they produce products that create environmental damage, both as a consequence of manufacturing and driving. Yet consumers will never give up cars. So it makes more sense to score the whole automotive sector, and overweight Toyota, which appears to be making the most strides.

"We believe environmental issues are woven into the entire economy," says Naimon. "Rather than thinking about what is green, we take the view that it is everywhere, from plastics makers and buildings, to computers and airplane companies, to oil and gas." Effective environmental managers obtain higher energy and resource productivity. They can enhance their margins, or save costs on the bottom line. "Think of managing environmental risk with some embedded alpha," says Naimon. In the chemicals industry, a company like Dupont has made systematic efforts to reduce the amount of resources used for production. IBM stands out from its computer industry peers, by taking responsibility for the end of its products' lives, with a large unit that refurbishes them, and acts as a profit centre.

From an investment perspective, does it make more sense to invest directly in green companies - to the extent you can find pure plays - or to take a broader view of green ramifications across the entire corporate arena? Going back two decades, Jupiter's Ecology fund demonstrates a positive track record of profitable returns in the sector itself. On the 20th anniversary of the fund's launch, it had racked up gains of 414%, versus an average of 343% in the global growth sector. Glancing back five years, Jupiter's fund was ahead by 138%, in contrast to 79.5% for the FTSE All-World index, and over the past three years up 55%, versus 32.8% for the FTSE All-World.

Yet although they have been profitable, green companies have dropped in and out of fashion. That is another reason for today's moves toward more indirect investing. Often used by investors as momentum vehicles, many of the original entities merged in the 1990s. Think of the original early 20th century automobile companies. What started as a wave of enterprise and innovation, consisting of hundreds of small firms, eventually consolidated into a small oligopoly. "If we try to track the massive global trend toward clean tech, we find an unstoppable demand, but a sector like alternative energy will be volatile," says Coven. By the end of the first quarter of 2008, big solar players were bleeding profusely, with SunPower down 49%, Evergreen Solar off 55% and Solarfun losing 65% as of March 31.

While the past year has seen both growing public consciousness and tangible capital infusions into the sectors, it is worth sounding a note of caution. There is little doubt that environmental awareness is a long-term secular trend. However, a substantial component of today's heightened focus is directly tied to the price of oil and any looming energy crisis. The price of oil and other commodities has skyrocketed over the past quarter, driven by a confluence of forces. Although light sweet crude has crossed \$120 a barrel, recall that, not so long ago, in mid-January 2007 it was only trading at \$50. Mean reversion could bring the price skidding down again.

Another scenario could easily dampen the ethical consumer's spending pattern, if a recession takes hold. "Are organic foods luxury items?" asks Thomas, who adds that so far this year, the organic trend has not slowed, even in America. The stocks of the companies trade at higher price-to-earnings valuations than those of non-organic rivals, and those lofty prices will increase the risks of compression in volatile markets. Meanwhile, competition is thriving along the supply chain, as new entrants squeeze margins.

The rise and fall of the dotcom stocks left behind bad scars and memories. Some may wonder if the fashion for environmental investing echoes the hype and exuberance of that era. Black, who was himself in San Francisco during the period, maintains that the green theme bears almost no resemblance to the internet in its giddy heyday. "The scale of bad ideas back then would make green look like a speck on the back of an elephant," he says. "Clean tech is not as sexy as the

internet, but it is about finding good science and addressing real problems." IT European renewable energy consumption Shows the percentage of renewable energies in the primary energy consumption of European Union countries in 2005.

### Ruminating on greenhouse gases

Are greenhouse gases in fact affecting the earth's climate? While that issue remains debatable, those who maintain they are point to carbon dioxide, sulphur dioxide, methane and nitrous oxides as the prime culprits. Methane, which has more than 20 times the warming effect of carbon dioxide, results from fossil fuel production, rice cultivation, biomass burning and waste management, not to mention wetlands, permafrost, oceans, fresh water and termites.

One of the most prodigious sources of methane production is the digestive process of ruminants: buffalo, cattle, camels, goats and sheep. According to the United Nations, livestock are the perpetrators of 18% of global greenhouse gas emissions. America's Environmental Protection Agency reports that enteric fermentation averages about 116 TgCO<sub>2</sub> equivalents, only slightly behind landfills and natural gas systems. Microbial fermentation performs a pre-digestive function in the rumen, or large fore stomach, of the beasts. Just one cow, which produces methane both from rear and front ends, can burp out up to 130 gallons (108 imperial gallons) a day. Livestock manure emits methane and nitrous oxide, as well. Other animals, including humans, are also methane belchers, albeit in much smaller quantities.

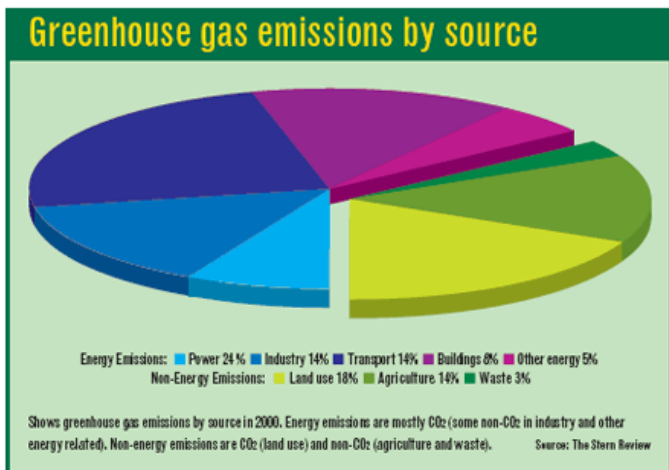
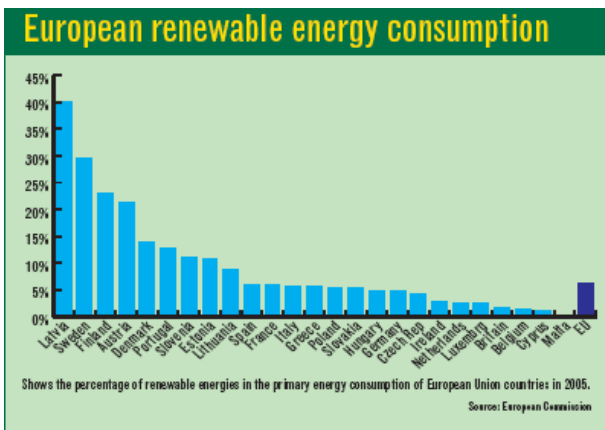
However, there are some ways to turn a sow's ear into a silk purse. "The waste-to-energy industry is one that seeks to turn waste into energy by burning it, or by using the by-product methane gas, which results from disposal of any organic waste, to generate heat and electricity," says Jim Mellon, co-author of "The Top 10 Investments for the Next 10 Years." He highlights several companies that are active in the waste recycling industry, including Shanks and Biffa in Britain, Laskila Tikonoja in Finland, Seche Environnement in France and the Japanese firm Daiseiki.

### Greening the brand

Many companies that did not start out their businesses with green intentions are shifting gear, as they realise how much it can help them to attract new customers and segments. "It's good for the brand, and makes customers feel better," explains Michal Ann Strahilevitz, professor of business administration at Golden Gate University in San Francisco. It also fattens the bottom lines, by saving on expenses like gas and electricity through recycling or driving shorter distances.

Walmart and Whole Foods are good examples. The food retailers have learned to refrigerate their products, such as yogurt, behind closed cabinets with doors. Previously, they spent more on electricity when they displayed the refrigerated items on open shelves.

Clorox is a case of a neutral brand, in terms of social responsibility. "They were selling cleaning products with no emphasis either way on the environmental impact," Strahilevitz says. After the company's own research indicated that almost half of its customers would be interested in green products if they were as effective as regular versions, the firm came out with its Green Works line, becoming a "light green company" as it targeted value conscious purchasers. "Sizeable capital spending is going into these efforts," says Charlie Thomas, manager of the Jupiter Ecology fund, who reports that last year HSBC committed £150m, Marks & Spencer £200m and Tesco £150m.



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