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Money's green, too

Evan Lorenz writes:

Venture capitalist Chamath Palihapitiya jolted the dozy viewers of CNBC's early-morning "Squawk Box" show into wakefulness last week with a declaration that ESG investing is a "complete fraud," a "joke" and "so ridiculous." Now *Grant's* renders its own judgment on the environmental, social and governance approach to buying low and selling high. In preview, we align more with Palihapitiya than we do, for instance, with do-good evangelist Larry Fink, CEO of BlackRock, Inc. On the editorial agenda is an overview of the ESG landscape and an analysis of a pair of picks that we say do not, and will not, click: Ormat Technologies, Inc. (ORA on the New York Stock Exchange) and Sunrun, Inc. (RUN on the Nasdaq).

While almost no one wishes to do the environment harm, there are costs to doing it good, as the CEO of Rio Tinto plc, Jean-Sébastien Jacques, reminded dialers-in on a Feb. 26 earnings call. "For consumers," said Jacques, "are you willing to pay a premium for services and products that are greener and to support developing nations? Are you willing to consume less? For governments, are you willing to sacrifice economic growth and associated jobs to deliver climate goals? And, for shareholders, are you willing to see a reduction in shareholder returns to finance climate action?"

And a further question, from us, for ESG promoters: Are you willing to gather the assets of a credulous public? This, at least, has a certain, emphatic answer.

Thus, LibreMax Capital LLC is marketing a collateralized loan obligation to be stocked with ESG-compliant debt. Perhaps a recent $550 million "sustainability loan" to JetBlue Airways Corp. from BNP Paribas S.A. might qualify. Interest cost will rise or fall depending on the borrower's ESG ranking as determined by a Moody's subsidiary called Vigeo Eiris (a Latin verb followed by an English acronym meaning, approximately, "looking for compliance with the green agenda of sincere environmentalists and left-wing opportunists").

Suddenly, green is the color of private equity, too. Bain & Co.'s brand new 2020 Global Private Equity Report features an 11-page ESG supplement, 11 pages more than the 2019 edition.

And while Bain, TPG Capital and others are raising green funds, Carlyle Group, Inc. is setting out to spray-paint its entire portfolio. Leading the effort is 32-year-old Megan Starr, who left Goldman Sachs Group, Inc. in June to become Carlyle's head of "impact."

"It's no longer possible to generate high rates of return unless you invest for impact," a Feb. 26 Bloomberg dispatch quotes Starr as saying. "It reflects the economic reality."

Investment results may prove a different reality. Over the past 10 years, the STOXX Global ESG Leaders index, whose component companies earn high ESG scores, has returned 117% versus 181% for the non-environmentally vetted STOXX Global 1800 index (both are priced in euros and include reinvested dividends).

Nonetheless, professionally managed, environmentally attuned assets in the United States will soar to $34.5 trillion in 2025 from $12 trillion in 2018, Deloitte predicts. If so, such funds would account for 50% of American assets in five years, up from 26% in 2018.

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Ormat Technologies, Inc. at a glance
all figures in $ millions

	2019	2018	2017	2016	2015
electricity sales	$540.3	$509.9	$465.6	$436.3	$375.9
product sales	191.0	201.7	224.5	226.3	218.7
other sales	14.7	7.6	2.7	0	0
total revenues	746.0	719.3	692.8	662.6	594.6
operating income	193.8	185.1	205.0	201.9	164.1
interest expense	78.9	70.0	53.2	66.4	72.3
net income	88.1	98.0	132.4	88.7	120.4
cash	71.2	98.8	47.8	230.2	185.9
debt	1,238.0	1,267.9	913.6	938.9	901.4
total assets	3,250.5	3,121.4	2,623.9	2,461.6	2,274.0

source: company reports

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Sunrun, Inc. at a glance
all figures in $ millions

	2019	2018	2017	2016	2015
revenues	$858.6	$760.0	$532.5	$453.9	$304.6
operating income	-215.7	-121.9	-181.1	-214.9	-219.2
interest income	174.2	131.8	92.3	53.2	33.2
net income	26.3	26.7	125.5	91.7	-28.2
cash	269.6	226.6	202.5	206.4	203.9
debt	2,593.9	2,112.7	1,452.4	1,064.8	715.7
assets	5,806.3	4,749.8	3,927.9	3,572.8	2,734.6

source: company reports

While there's no proof that more highly ranked ESG stocks outperform those without environmental, social and governmental bonafides, renewable-energy names have zipped to the stratosphere. Despite a 9.1% drop on Feb. 26 after reporting fourth-quarter earnings, Reno (Nev.)-based Ormat has rallied 101% since year-end 2015, versus a 60% return for the S&P 500. Ormat's outperformance is owing not to surging sales or revenues (up 5.8% at a compound annual rate since 2015 versus 5.9% for the S&P 500) or earnings (down 8.4% versus a rise of 8.6% for the index), but to reputed greenness.

Ormat builds small-scale, binary geothermal plants, with the emphasis on small. A typical Ormat installation might generate 30 megawatts of power compared with the 400 MW capacity of a standard combined cycle-gas turbine. Binary systems pump hot water or brine from inside the earth to heat a secondary fluid that runs a turbine.

Besides operating geothermal power plants ($540.3 million in sales and $177.2 million in operating income last year), Ormat designs and manufactures components and power plants ($191 million and $23.2 million) and sells batteries and related services ($14.7 million and a loss of $6.6 million).

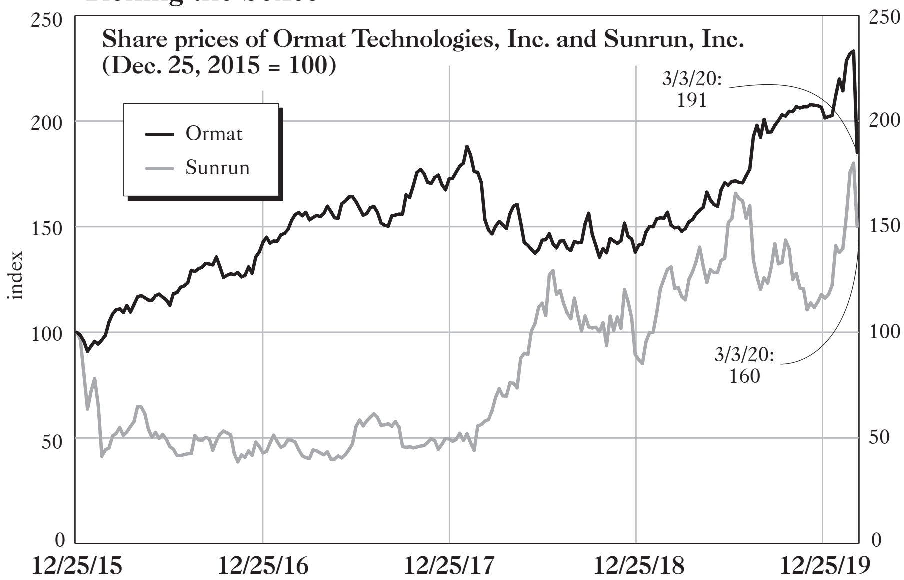
You'll find Ormat's facilities from California to Indonesia, and while domestic customers generate most of the revenue, it's the emerging markets that bring in the earnings. In 2019, the international portion of the electricity division accounted for 28% of total revenues, 52% of gross profit and 59% of net income.

As power options, wind and solar happen to be cheaper than geothermal in many parts of the world. "Suffice it to say," Gerry Sweeney, who rates Ormat neutral at Roth Capital Partners, tells me, "geothermal trades at a higher cost, but it is baseload power. Wind doesn't always blow and the sun doesn't always shine. You need a portfolio approach when it comes to your power output. Geothermal is the only true renewable that is also baseload."

Last week's smackdown nonetheless leaves Ormat trading at 41.1 times trailing net income. As of Dec. 31, Ormat's net debt footed to $1.2 billion, or 3.1 times trailing earnings before interest, taxes, depreciation and amortization. Last year, operating income covered interest expense by 2.5 times; short interest stands at 1.7% of the float.

Reflecting the sell-side consensus, J.P. Morgan Securities judges the company to be sound ("based on relative balance sheet strength, earnings power and visibility") and the shares "fairly" valued.

Ticking the boxes



source: The Bloomberg

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Ormat's problems begin abroad. At last report, Kenyan operations, consisting of four power plants, contributed—as management put it a while back—"disproportionately" to net income. The facilities, collectively known as the Olkaria 3 Complex, are under power-purchase agreements that expire between 2033 and 2036.

The trouble here is twofold. First, rates on PPAs worldwide are in decline. It means that each additional investment will lower Ormat's overall return on invested capital.

Second, Ormat's earnings are hostage to good relations with one customer, that being the slow-pay Kenya Power and Lighting Co.; on Dec. 31, its past-due balance stood at $40.7 million.

"I could understand the temporary over-earnings if the Kenyan grid was undersupplied and the government needed to attract more outside private investment," says Zachary Truesdell, co-founder and portfolio manager of Matador Global Management. "But it seems like they are getting ample funding from the Japanese, the Chinese and other channels now. Kenya is expanding capacity dramatically, even as they've lowered their outlook for power demand. They recently added Olkaria 5, a geothermal facility in the Great Rift Valley. It is bigger than Olkaria 3, Ormat's facilities in Kenya. They are adding Olkaria 6 in the next

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year or two, and it will also be as big or bigger." Ormat is only involved with the Olkaria 3 complex.

Truesdell, who is short the stock, says that, as far as he can determine, Ormat is earning around $94 for each MWh of power, more than double the $45 per MWh that a local geothermal competitor, Kenya Electricity Generating Co., collects. In Kenya, Ormat exacts a fee for both the sheer existence of its installed 150 MW capacity and the power it actually generates. In recent earnings calls, Ormat has complained about the curtailment of Kenyan energy demand. Our calls for clarification, to Reno and Nairobi, went unanswered, but it would not seem unreasonable if Kenyan consumers chose the half-off option.

In the absence of free cash flow (from 2016 through 2019, there was a deficit of $323.4 million), Ormat funds itself in the capital markets, but there are difficulties beyond that bare fact. In December, management received a dunning notice from the Kenya Revenue Authority for $228 million in back taxes for 2013 through 2017. "We will probably start to pay taxes in Kenya sometime in 2020," CFO Doron Blachar said at the end of the Feb. 26 earnings call.

There are questions, too, concerning Ormat's C-suite. Before taking the Ormat helm, Isaac Angel was the chief executive at Lipman Electronic Engineering Ltd., which Verifone Holdings, Inc. acquired in 2006 for a $793 million consideration. Financial irregularities at Lipman contributed to Verifone's paying $95 million in a class-action settlement and to the resignation of Verifone's CFO.

Prior to joining Ormat, Blachar was the CFO at Shikun & Binui Ltd., an Israeli construction company, from 2009 to 2013. In May, Israeli police announced an investigation into Shikun, alleging a history of bribery in Africa with a focus on Kenya from 2008 to 2016.

Over the past 12 months, insiders have sold 105,299 shares for net proceeds of $7.4 million. Some insiders are also voting with their feet: In the fourth-quarter earnings release, Angel announced he would be stepping down as CEO effective July 1 to make room for Blachar.

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Sunrun, the company behind the share price that has leapt by 131% since March 23, 2018—that being the cover date of the issue of *Grant's* that judged it deserved to plunge—is the largest installer of residential solar panels and battery systems in the United States.

The corporate M.O. is to sign customers to a 20-year lease agreement: RUN fronts the cost to install the panels (approximately $22,100), and the customer agrees to make monthly payments with annual escalators. At the end of the term, the lessee has the option to renew for an additional 10 years. As of Dec. 31, 2019, RUN had an installed base of 1,987 MW worth of panels across 22 states, Washington, D.C. and Puerto Rico.

RUN measures the value of its portfolio with a bespoke metric called "net earning assets." To solve for this homegrown datum, assume that 100% of customers renew for an additional decade; you must assume because the company is only 13 years old. Next, discount the contracted payments ($27,300) and renewal payments ($3,400) at a 6% rate. This yields a $8,700 net present value for the average customer. As of Dec. 31, 2019, RUN's net earning assets, which adjust for project-level debt, foot to $1.5 billion, an 8.4% year-over-year rise.

Favorable legislation, lower interest rates and, of course, the halo of environmental virtue have sustained the company and its share price alike. As to legislation, California has mandated that all newly built homes come equipped with rooftop solar panels beginning Jan. 1. The Golden State accounts for more than 40% of Sunrun's customer base. As to interest rates, RUN placed the senior tranche of a solar-panel securitization in October at a cost of just 3.63%. Taking note, BofA Global Research analysts declared that the management-ordained 6% discount rate is conservative to a fault, and they revised down their own discount rate, to 4.5% from 6%. Up, therefore, went the implied present value of the stock.

If company-provided, non-GAAP metrics encapsulate the bull case, the cold figures on file with the Securities and Exchange Commission lend support to—even, we say, clinch—the bear argument. Thus, last year, Sunrun generated negative Ebitda of $28.6 million, negative operating income of $215.7 million and negative cash flow from operations (less capital expenditures) of $1 billion. At year-end, there was $2.3 billion in net debt.

The California mandate isn't the ticket to rent-seeking corporate riches that it might appear to be. Most big homebuilders already have their own solar units. Lennar Corp., for instance, a bullish selection in the issue of *Grant's* dated July 26, 2019, has its SunStreet Energy Group. And SunStreet, unlike RUN, guarantees that the panels it installs will save the homeowner 20% of the cost of prevailing utility rates over 20 years. Nor must the buyer lock himself into a two-decade lease.

Since the median California home price tops $560,000, homebuilders are alert to ways to mitigate sticker shock. To that end, Sacramento builders recently petitioned the California Energy Commission for cost relief and—just last month—won. Instead of adding the price of solar panels to an already steep home price, builders may now take credit for off-site solar power produced by the Sacramento Municipal Utility District. Homebuyers thereby save the installation cost of about $20,000. Expect other builders to demand a similar workaround.

Just how RUN came to assume that any, never mind all, of its lessees will choose to renew after 20 years is a good question. If Better Business Bureau ratings are any guide, renewal rates may fall slightly short of that projected 100%. "I am beyond appalled at how terrible my experience with Sunrun has been, I would never recommend this company to anyone," said a one-star review dated Dec. 18. Overall, according to the BBB, Sunrun earns 1.5 stars out of five. Sentiment isn't much better on 21st-century consumer sites; on SolarReviews.com, the company earns two stars out of five.

An errant renewal rate could cause a big swing in RUN's net-present-value calculation. After an investigative report by Arizona's Family, a Phoenix, Ariz. news network, RUN agreed to yank one local homeowner's panels. In addition to the costs of removal, Sunrun cut her a $3,100 check for repairs to her roof, according to a March 19, 2018 dispatch from the same site.

Let's assume, for one moment, that it costs Sunrun $5,000 to pull the panels and fix the roof of an ungrateful customer. Discount that figure back 20 years at a 6% rate, and you're left with a

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cost in present dollars of $1,559. To run through Sunrun's fourth-quarter math: The company projects discounted, contractual payments of $27,300, the cost to install panels is $22,100 and the present value to remove panels in two decades is $1,559, resulting in a net present value of $3,641, or less than half of RUN's projected $8,600 net present value.

With eight buys, three holds and no sells, the Street is favorably disposed to the stock. Bears have shorted 23% of the float. Selling 1.4 million shares for proceeds of $24.6 million, insiders seem to line up with the critics.

On "Squawk Box" two Wednesdays ago, the afore-quoted Palihapitiya, who's the founder of Social Capital, an early executive hire at Facebook, Inc. and an environmental advocate, acknowledged that ESG is "great marketing." But, he added, "It's a lot of sizzle, no steak."

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