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CAPITAL MANAGEMENT

Driehaus Emerging Markets Small Cap Equity Strategy Summary

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The global energy landscape is amid a period of uncertainty, stemming from several factors. With a new US administration comes a new set of regulatory priorities, leading to lower visibility for both renewable as well as conventional energy markets. Oil and refined products have faced the dual headwinds of meager global demand growth and ample supply from key producing nations.

COP29, the annual climate summit, recently concluded in Azerbaijan. Past COPs have featured large commitments to the adoption of renewable energy and goals around net-zero emissions. While expectations were more subdued around COP29, the summit achieved progress in areas such as carbon markets and climate finance, setting the stage for COP30 next year in Brazil.

After years of negotiations, COP29 operationalized the components of the Paris Agreement related to carbon markets. This included clear rules for international trading of carbon credits, enhancing transparency. The UN carbon market is set to launch in 2025, with implications for voluntary carbon credit markets and corporate climate strategies.

Additionally, an agreement was reached to triple annual climate finance for developing countries from $100 billion to $300 billion by 2035, in the context of a broader target to mobilize $1.3 trillion annually by 2035 from public and private sources. While these commitments are significant, questions remain about how these goals will be achieved.

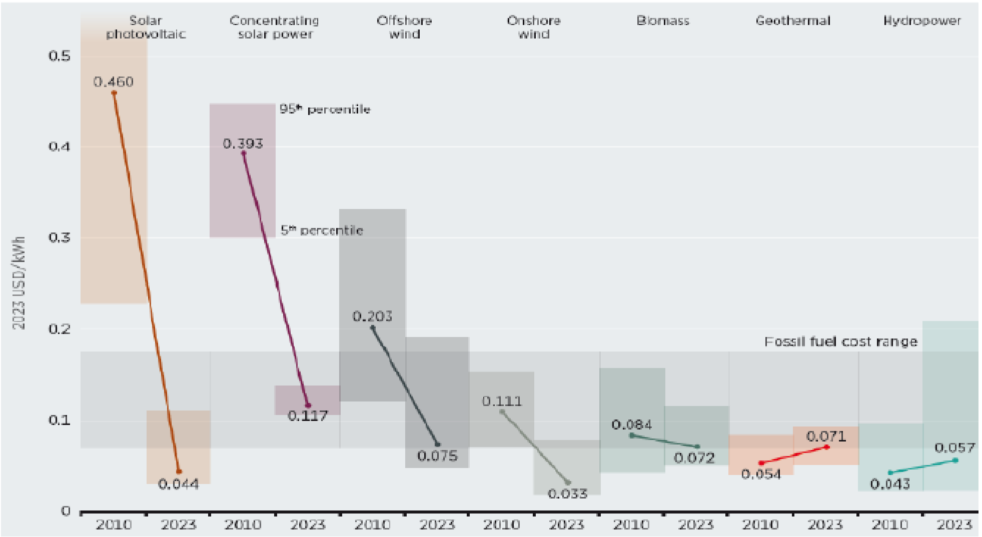
While COP29 is unlikely to represent an equity market catalyst, we continue to be optimistic about a long-held position in a Brazilian waste treatment company that stands to be a winner from an improving backdrop for carbon credits.

This company has a unique business model that generates carbon credits through the operation of ecoparks, its core business, a concept which has evolved from conventional landfills, placing heavy emphasis on recycling and the circular economy. In the company's own words, "the main difference between an ecopark and a regular sanitary landfill is the understanding that waste is not material to be discarded and isolated, but rather a rich raw material to be reintroduced into the production chain." For example, from these ecoparks, the company captures biogas produced from waste decomposition, preventing methane emissions, while simultaneously producing biomethane. Ongoing improvements to the transparency and adoption of carbon credits bode well for the company to capture this highly profitable revenue stream.

The renewable energy industry is navigating a complex landscape marked by regulatory uncertainty, regional disparities, and evolving market dynamics. Throughout the solar supply chain, which remains dominated by China, overcapacity has developed, pushing down prices. As a result, solar's levelized cost of energy continues to fall, and is now well below that of fossil fuels (Exhibit 1).

The demand response to these cost declines has diverged across regions, with China solar installations running at +25% year-over-year through the first nine months of 2024, while the US grew by 16% and Germany is lagging, with 4% growth. Under a Trump administration, the outlook for US solar faces increasing risk, particularly on the residential side, while suppliers face the growing risk of tariffs.

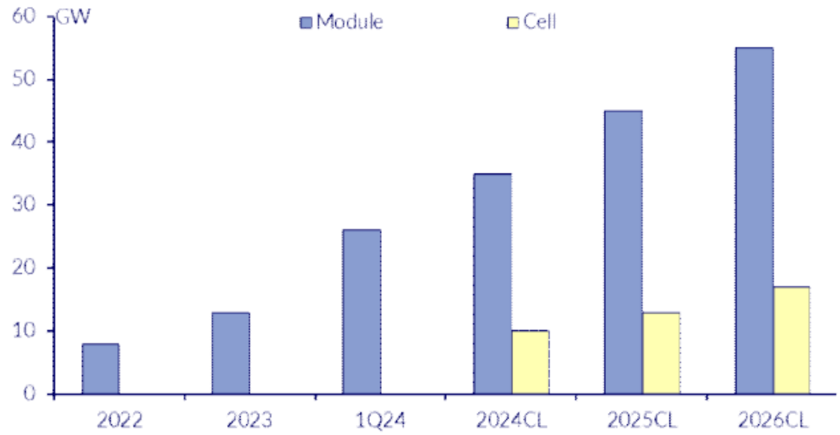
Exhibit 1. Global Levelized Cost of Energy (USD/kWh)



Source: BofA Global Research, IRENA

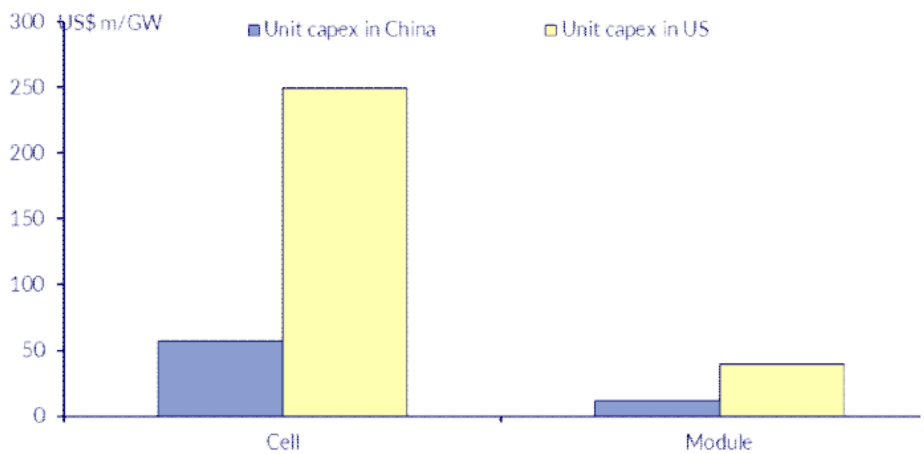
The US has been successful in building domestic solar module capacity in recent years (Exhibit 2). However, this may prove more challenging in other parts of the supply chain, such as cells, where technological advantages are more apparent. As shown below, the unit capex to build solar cell capacity in the US is 5x that of China (Exhibit 3). Even if tariffs were to engineer a more level playing field, the economics to build new supply are less clear.

Exhibit 2. US Solar Capacity



Source: WoodMackenzie, CLSA

Exhibit 3. Unit Capex Comparison Between the US and China



Source: CLSA, companies

The strategy has minimal exposure to renewable energy, due to the headwinds described above. However, one country that defies this trend is India, where policymakers continue to aggressively push for new capacity to meet longer-term targets around decarbonization. The strategy maintains a position in a leading producer of wind turbine generators, which is benefiting from strong bargaining power, stemming from a concentrated market experiencing accelerating demand growth.

Malaysia is another country that is well positioned to take advantage of the declining input costs throughout the solar supply chain, while simultaneously tapping into the demand growth from datacenters. The strategy holds a position in a utility company, which plans to ramp up new solar capacity alongside an artificial intelligence datacenter (AI DC) next year.

While renewable energy has expanded rapidly in recent years, conventional energy sources remain critical, particularly in emerging markets and energy-intensive industries. Liquefied natural gas (LNG) appears to be a likely beneficiary of easing regulation around new project permitting in the US. South Korean shipbuilders are driving innovation in LNG transport with dual-fuel vessels. These advancements are critical as LNG continues to play a transitional role in global energy markets.

We recently met with the management of a leading Korean shipbuilder, who indicated that dual-fuel ships will start to flow through the income statement in the coming year, carrying higher margins than the legacy backlog. With steel plate prices remaining subdued, and major shipyards already booked out for the next four years, pricing power remains strong, pointing to multiple drivers of margin expansion.

With oil remaining in a surplus amid continued strong US production, subdued global demand growth, and a high degree of spare capacity in Saudi Arabia, alpha generative opportunities in the sector have largely been found in idiosyncratic stocks. Argentina has represented a strong source of performance within the energy sector, as the Milei administration continues to deliver on its reform agenda, leading to a lower equity risk premium and expectations of stronger earnings from leading players. Two energy producers held within the portfolio maintain significant positions in the country's Vaca Muerta shale formation. These companies have delivered strong production growth, and the eventual loosening of capital controls, alongside the delivery of new pipeline infrastructure, should lead to a further acceleration.

The strategy remains overweight energy, although the sector carries a low weighting of 1.7% in the MSCI Emerging Markets Small Cap Index. While our base case is for rangebound oil prices amid ongoing market surpluses, we believe the idiosyncratic fundamentals of specific stocks tied to themes such as carbon credits, the adoption of renewable energy, the growth of LNG, and the development of new resource bases like the Vaca Muerta represent sources of alpha despite the challenging macro and uncertain regulatory conditions in the industry.

Until next month,

Chad A Cleaver

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