Brookfield

# The Time Is Now for Investing in the Climate Transition

**PUBLIC SECURITIES GROUP**

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Companies at the forefront of transitioning essential services toward a more reliable, resilient and cleaner future appear to be reaching an inflection point. Equity returns of companies driving these global transitions have lagged broader market indexes in recent years. However, a shifting investment landscape suggests to us that many companies are mispriced relative to the strong supporting tailwinds for climate transition investments, such as decarbonization, energy security, grid reliability and the circular economy.

We believe there are tremendous long-term investment opportunities as corporations and governments continue to decarbonize the global economy, interest rates begin to move lower, and the overhang of political uncertainty nears clarity. With the climate transition megatrend still in its infancy, we do not see a better time to strategically allocate to the space, given the compelling long-term return proposition and the complementary nature to traditional power and energy exposure.

## A Multi-Decade, Multi-Trillion-Dollar Megatrend

The transition to a decarbonized and circular economy with better resource efficiency represents what we believe to be the largest investment opportunity of the decade. Trillions of dollars will be invested annually in coming years to meet growing demands for clean, reliable sources of electricity, a circular and efficient resource consumption system, and evolution of the demand for natural resources. Investment opportunities across the spectrum for climate transition will be driven by several demand drivers.

- **Stakeholder Alignment:** The stakeholders include governments, asset owners and corporations that are committed to reducing global emissions. Corporate demand for clean power is a key driver of decarbonization; and the largest energy consumers are contracting directly with utility-scale renewable power providers to source long-term sources of clean energy.
- **Costs:** Renewable power is the lowest-cost source of bulk new power.[1] The levelized costs of energy for wind and solar projects have significantly declined over the past decade, despite an uptick in costs for new builds in recent years. With onshore wind and solar costs at about 50% of the costs of some traditional fossil fuels, new renewable power development is set to overtake coal-fired power in 2025.
- **Digitalization and Deglobalization:** The power industry is benefiting from tremendous growth in electricity demand. Above-average global electricity demand growth is driven by a step-function change in power demand related to data centers, artificial intelligence (AI) and increasing industrialization. There is an urgent need to revitalize and expand the world's electrical infrastructure to not only meet this higher demand, but also to adapt networks for new sources of power generation. As a result, transmission and generation capital expenditures are increasing to modernize networks and boost energy efficiency and reliability. Additionally, more sustainable solutions promoting energy efficiency and reducing excess electric usage are increasingly sought after to help balance new power demand centers with the changing landscape of where and how power is supplied.
- **Health and Safety:** Innovative solutions are required to address decades of underinvestment in water and waste infrastructure. Governments are partnering with water and waste utilities to shore up systems, ensure safer operations, and strengthen these systems so they are resilient to natural and man-made threats. We believe that water technology, utilities, and waste and recycling companies are well positioned to benefit from billions of dollars of investments in the coming decades.
- **Security:** Energy security and independence are a growing necessity. Renewable sources of power contribute to energy security by diversifying sources of electricity, reducing reliance on other nations for power, and providing stored energy across grids and battery storage.

[1] As of September 2024. Source: Brookfield Asset Management, Bloomberg New Energy Finance, Real 2022$.

### Stakeholder Alignment

Decarbonization is a shared goal across stakeholder groups

### Costs

Renewable power is the lowest-cost source of new power

### Digitalization and Deglobalization

Electricity demand is accelerating from data infrastructure and industrial growth

### Health and Safety

Water and waste investments bolster human health and the security of industries reliant on water systems

### Security

Renewable power sources contribute to energy security and independence

As of October 2024. Source: Brookfield Public Securities Group.

## Moderating Financing and Input Costs

Funding long-duration projects, particularly in the wind sector, became more expensive in recent years, as restrictive monetary policies led to elevated financing costs. Higher funding costs led to a slowdown in renewables project development, particularly offshore wind projects (which were also impacted by challenging supply chain conditions). For example, in 2023, developers canceled or postponed at least 15 GW of offshore wind projects in the U.S. and United Kingdom.

However, interest rate headwinds appear to be abating, as central banks around the world cut rates. Financial conditions are likely to ease—and financing costs are likely to fall—as interest rates normalize. We believe normalizing rates should help ease the increasing capital costs for new projects, helping to restore project timelines that had been otherwise delayed. Overall, we think positive economics for new projects continue to improve, as input costs have come down amid falling inflation and supply chain headwinds that are starting to subside.

Stakeholders across the utilities spectrum stand to benefit from lower rates and moderating input costs. Regulated utilities can keep customer bills lower, while they raise the necessary capital to spend on transition projects (which have been straining government balance sheets). Many projects that were put on hold amid higher financing costs could reaccelerate, reigniting the renewable power build-out and benefiting customers, governments and investors.

## Political Clarity Coming Into Focus

Political uncertainty has exerted pressure on renewable energy equities, as investors await clarity on implications of key elections. As key elections around the globe have passed, we see this near-term overhang to sentiment receding. In particular in the U.S., despite heightened rhetoric on the campaign trail, many experts do not anticipate widespread policy changes that will impact the pace of decarbonization.

Recent U.S. legislation introduced key policies to encourage clean power and decarbonization efforts. The 2022 Inflation Reduction Act (IRA) set aside hundreds of billions of dollars for solar, wind and battery storage investments, among other areas. This included funds for onshore manufacturing for components throughout the clean energy supply chain, as well as incentives for investments in clean energy generation. Additionally, the 2021 Infrastructure Investment and Jobs Act (IIJA) included funding to modernize power grids for the energy transition, as well as investments to improve drinking and wastewater systems.

While some climate transition policies might be modified on the margin, we believe widespread overhauls are unlikely. These programs enjoy bipartisan support, given that thousands of new jobs have been created in U.S. states spanning the political spectrum, at companies that are driving investments to combat physical and transition risk.

## Breaking Down Perceived Election Risk for Clean Energy

Top 10 states for clean energy project announcements following the IRA

| Location | Presidential Election Result | | | Projects | New Investments ($billions) | Job Creation |
|---|---|---|---|---|---|---|
| **U.S.** | **2016** | **2020** | **2024** | **646** | **372.9** | **334,565** |
| Michigan | Rep | Dem | Rep | 62 | 26.6 | 21,748 |
| Texas | Rep | Rep | Rep | 52 | 17 | 24,122 |
| Georgia | Rep | Dem | Rep | 45 | 23.9 | 32,191 |
| California | Dem | Dem | Dem | 43 | 11.4 | 11,007 |
| South Carolina | Rep | Rep | Rep | 36 | 15.1 | 18,124 |
| Ohio | Rep | Rep | Rep | 28 | 10.4 | 13,887 |
| North Carolina | Rep | Rep | Rep | 27 | 19 | 11,850 |
| Tennessee | Rep | Rep | Rep | 25 | 5.6 | 6,725 |
| Arizona | Rep | Dem | Rep | 24 | 11.8 | 18,130 |
| New York | Dem | Dem | Dem | 23 | 115.4 | 28,934 |

Source: Brookings Institute. Climate Power, accessed September 2024; data is from public announcements by the private sector since the passage of the Inflation Reduction Act (IRA). Dem denotes a democratic win of electoral votes; Rep denotes a republican win of electoral votes.

# Balancing Factor Exposures

Approaches to investing in the climate transition to mitigate the impacts of physical and transition risk can vary widely. In our view, a balanced approach across investment factors can help maximize long-term client outcomes and avoid unintended investment outcomes. We outline several observations on allocating across this unique investment universe.

**Electricity Infrastructure and the Circular Economy:** Utilities and power providers are more capital-intensive businesses with historically higher emissions. Allocators seeking to capitalize on the decarbonization theme may prefer underweight exposure to these sectors, given a less favorable view of current sustainability practices. These portfolios may be underexposed to the stable cash flows and defensive investment characteristics they offer in volatile market conditions. They may also be under-allocated to high-quality companies that are taking steps to improve sustainability and work toward decarbonization goals.

**Sustainable Solutions:** Essential technologies that will drive the transition toward cleaner energy systems and sustainable business practices are a key component of the investment universe. These companies, which are engaged in the supply of solar PV and wind equipment, battery and energy storage, and grid modernization solutions, tend to exhibit higher exposure to growth factors. However, like many emerging-technology-focused investments, they may lack wider moats and therefore exhibit higher near-term volatility.

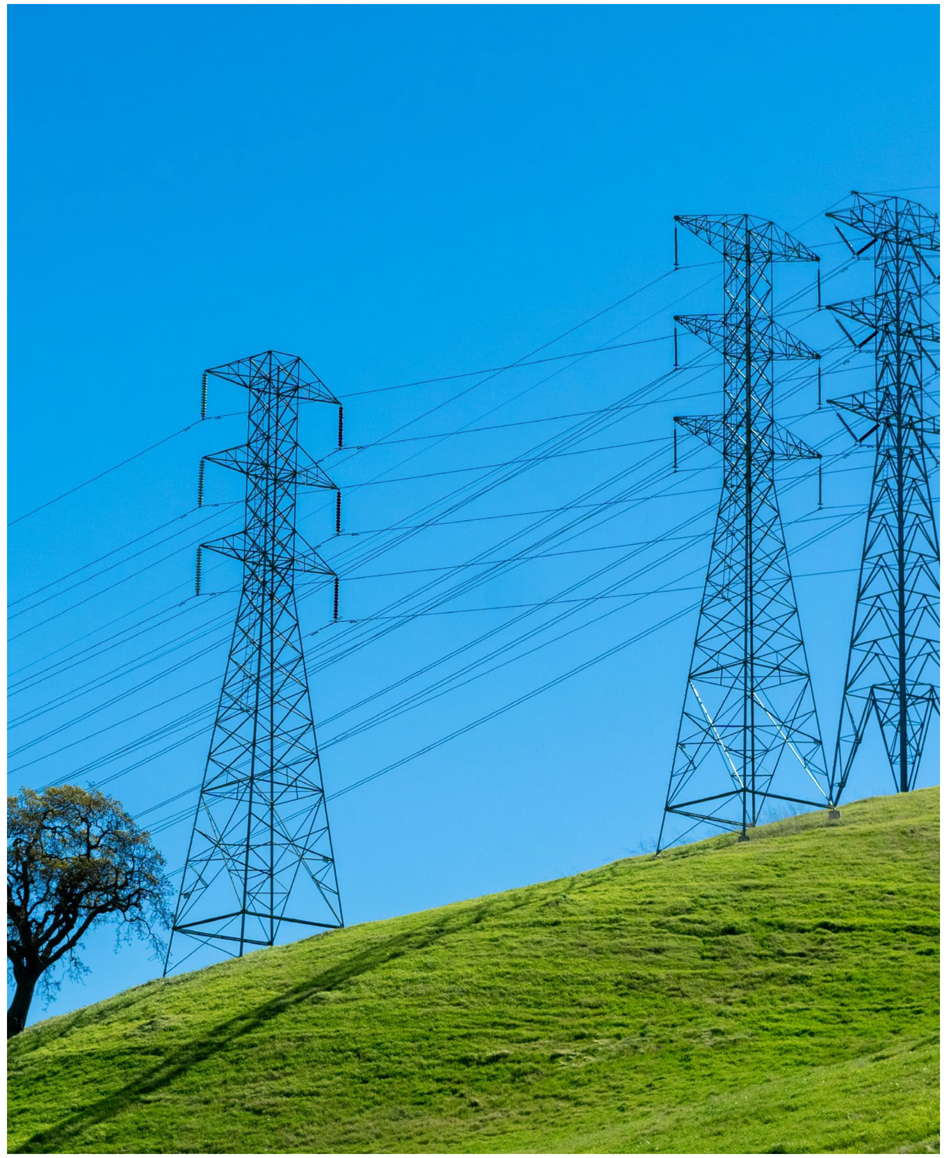
We advocate for a balanced investment approach across asset types and risk profiles. In our view, investors may benefit from a portfolio anchored around less cyclical business models, with visible cash flows and higher barriers to entry. Combined with growth-oriented companies that offer goods and services to facilitate clean power and the transition, we think investors may experience superior total-return outcomes.

### A Strategic Allocation to Shifting Energy Mixes

We believe a strategic allocation to transitioning essential service companies allows investors to access this generational investment opportunity. It also offers a holistic approach to climate transition investing, as owning companies that will generate clean power, provide necessary electric infrastructure, accelerate water and waste system investments, and provide the necessary sustainable solutions to manage these assets over the next several decades complements portfolios invested in traditional power and energy providers.

While the performance of certain renewables equities has suffered in recent years as a result of higher interest rates and elevated input costs, those challenges appear to be receding. We think investors should be encouraged by the long-term demand drivers, and abating near-term headwinds, as rates move lower and political uncertainty decreases. With a broader focus to the climate transition beyond new wind and solar investments, investors stand to benefit from this diversification.

We see stocks repricing to align with what we believe is the long-term growth opportunity. That said, the climate transition growth story will not unfold in a straight line.



**We think an active investment approach–supported by in-depth understanding of investment drivers and policy implications–helps manage risk and identify the most attractive opportunities.**

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