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NextEnergy Solar Fund

NESF offers a high, well-covered dividend yet trades on a discount to peers...

Summary

Update
13 October 2020

NextEnergy Solar Fund (NESF) invests in solar power plants, aiming to generate a total return for shareholders of 7–9% a year, including an attractive level of dividend. NESF is managed by NextEnergy Capital Group, a solar power specialist which operates at all stages of the value chain, from development through to asset management and fund management.

NESF's dividend was comfortably covered by cash earnings at the end of the 2020 financial year in March, and the board felt able to raise the target level by 2.6% for 2021, to 7.05p. This represents a yield of 6.8% on the current share price. Since IPO, the dividend has been increased in line with RPI, but as power prices are currently less correlated to RPI inflation, this linkage is under review.

Falling power prices have been a feature of the market since NESF's IPO in 2014. Nevertheless, it has managed to maintain its NAV, and has increased its dividend in line with RPI each year. This is partly due to the manager's expert knowledge of the market through its experience as a developer and asset manager. As discussed in the **Portfolio section**, this is indicated by the consistent delivery of 'asset management alpha'. This is generating excess power, and hence revenues, relative to that expected from an asset when acquired.

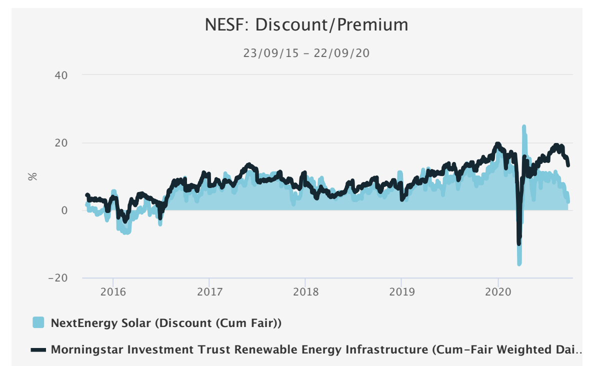
Despite the dividend being covered 1.2 times by cash, and the track record of strong asset management success, NESF's premium remains modest relative to peers. As discussed in the **Dividend section**, the shares trade 7% above par, compared to 9.2% for Foresight Solar Fund and 17.7% for Bluefield Solar Income Fund.

Analysts:

Thomas McMahon
+44 (0)203 795 0070

Key Information:

Price (p)	103.4
Discount (%)	7.0
OCF (%)	1.1
Yield (%)	6.8
Ticker	NESF
Market cap (£)	605,659,843



Kepler View

The disparity between the premium of NESF and its two mature peers is hard to justify, and seems to us to be an anomaly. NESF's assumptions regarding its NAV are not aggressive, and are actually more conservative than those of at least one of its more highly rated peers. If anything, this means the NAV is understated relative to peers, and the disparity between NESF and Bluefield Solar Income Fund in particular is therefore even larger.

Managing to generate stable NAV returns since IPO in a period of falling power prices is in itself an achievement, and NESF's revisions to the discount rate and expected asset lives have been relatively restrained. The manager's strong track record of adding value via excess power generation, as discussed in the **Portfolio section**, and reduction in operating costs has been a key feature. We think this is especially attractive when combined with the expertise and market knowledge the manager has via its development and asset management activities, which give it visibility on new developments, new technological innovations and pricing.

NESF's share price has not yet recovered from its post-COVID slump, and we think there is therefore a clear case for switching from peers to NESF on valuation grounds alone. Furthermore, over the long term we believe NESF's managers have proved adept at optimising the company's assets to the benefit of shareholders, which puts it in good stead over the medium to long term too.

BULL
High dividend, well covered by cash earnings (1.2x)
Specialist manager with demonstrable expertise in development, asset management and fund management as well as in energy sales
Anomalously low premium relative to peers, despite conservation NAV assumptions

BEAR
If power prices fall, cash flows and NAV will come under pressure, although a recovery from COVID-19-induced lows in power prices are already occurring
Valuation of assets difficult for non-specialists to assess
High levels of gearing (72% of NAV) including the preference shares, although preference shares have advantages and overall levels are not out of line with peers

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Portfolio

NESF owns a portfolio of 90 solar power assets, 82 of which are in the UK and the remainder in Italy. While the major focus is likely to remain on the UK, the board received permission at the last AGM in September 2020 to invest up to 30% of gross asset value (GAV) outside the country, up from 15% hitherto. This is intended to allow the c. £1bn GAV Guernsey-domiciled company to grow via attractively priced acquisitions – the manager believes that there is too much capital chasing too few opportunities in the UK, and as a consequence some of its peers are acquiring assets at higher prices than it finds acceptable. Regular share issuance has seen NESF's NAV grow from just £85m at launch in April 2014 to £576m. We understand future acquisitions are likely to broaden out the geographical footprint of the portfolio even further, rather than increasing the exposure to Italy.

NESF is managed by NextEnergy Capital Group (NEC), which specialises in the solar power sector. As we discuss fully in the **Management section**, NEC is a developer and asset manager as well as a fund manager in the space, and this gives it advantages in sourcing assets, assessing their attractiveness and generating alpha. NEC began as a developer of Italian solar plants, and in 2008 set up a wholly owned subsidiary WiseEnergy, which since then has been employed to perform asset management work for both external and internal clients. We understand WiseEnergy currently has c. 2,300MW of assets under contract, which compares to the 755MW capacity of NESF's current portfolio. As an asset manager, WiseEnergy has operated 1,500 utility-scale power plants since 2008. The manager believes that this significant long-standing presence and knowledge at every stage of the solar process gives WiseEnergy a huge advantage in terms of knowledge of its assets and the factors affecting the assets' performance, as well as of technical specifications. WiseEnergy has also developed proprietary IT platforms with hard- and software solutions to manage and monitor solar assets. In this light we would be inclined to trust the managers' reservations about the pricing of solar assets in the UK right now, and also their decision to expand the portfolio overseas.

We believe evidence of this expertise comes through in the strong performance of the assets versus their expected output. NESF reports this as 'asset management alpha': the extra energy generated over what was budgeted for, factoring in any deviation of irradiation (sunlight) experienced versus expectations. The below table shows NESF's track record since IPO in 2014. In each year the manager has generated more energy than expected, even when irradiation was below expectations. This has been true despite the rapid expansion of the portfolio from six assets initially to the current 90 (regular share issuance has seen the NAV grow from just £85m at launch in April 2014 to £576m).

Operational Performance Since IPO

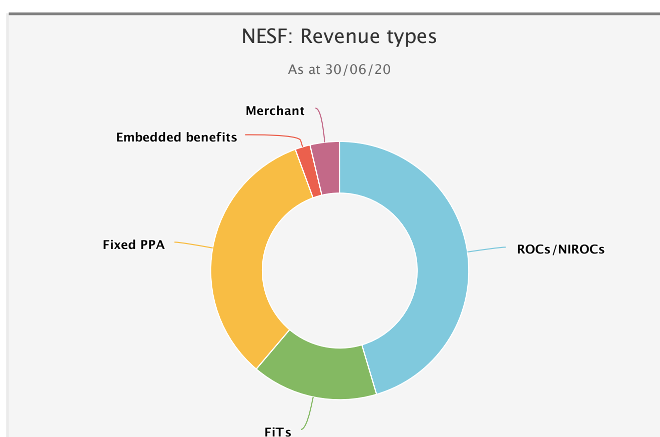
	ASSETS MONITORED	IRRADIATION (DELTA VS BUDGET)	GENERATION (DELTA VS BUDGET)	ASSET MANAGEMENT ALPHA
2015	6	-0.40%	4.8%	5.2%
2016	23	0.40%	4.1%	3.7%
2017	31	-0.30%	3.3%	3.6%
2018	55	-0.90%	0.9%	1.8%
2019	84	9.0%	9.1%	0.1%
2020	85	4.0%	4.7%	0.7%

Source: NESF

The asset management expertise also comes through in the ability to squeeze operating costs. In the year to 31 March 2020 these were 8.6% below the budgeted level, in FY 2019 they were 7.8% below budget and in FY 2018 they were 6.2% above budget, for an annualised saving of 3.2% versus budget over the past three years. We understand that one key focus area for 2021 is the continued reduction of NESF's operating expenses.

Almost half (45.4%) of the revenues for the portfolio come from renewables obligation certificates (ROCs), and 15.8% from feed-in tariffs (FiTs). These revenues are largely fixed, and only vary by the amount of electricity a company produces. NESF usually fixes the rest of its revenues (from sales of electricity) through forward contracts arranged by its dedicated trader, although for reasons explained in the **Dividend section**, it left a part of its capacity unhedged earlier this year.

Fig.1: Revenues By Type



Source: NESF

Following the closure of the UK ROC scheme to new generating capacity in 2017, any new acquisitions for NESF are either previously-built plants or subsidy-free. In selecting the best subsidy-free projects, NEC's leading and large footprint in the industry is again an advantage. In fact, NESF has already developed and built subsidy-free

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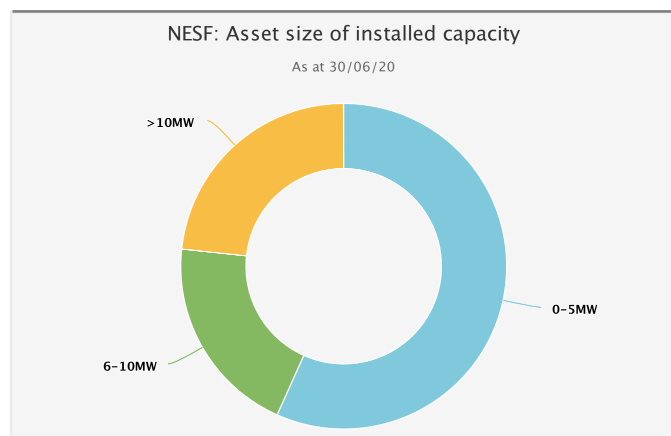
plants in the UK and is the only listed fund to have done so. NESF has additionally identified a pipeline of 773MW of development projects. With the trust's intention to allocate only 150MW of the portfolio to subsidy-free by the end of the 2021 financial year, this means there is significant scope to be selective. All the projects in the pipeline are expected to generate an ungeared 7–9% annualised return, in line with NESF's objective. The scale of the pipeline means that NESF's managers can afford to dispose of projects when they think future returns will not meet this, and in recent months the trust has disposed of two subsidy-free projects, Strensham and Llanwern.

Subsidy-free assets currently only contribute 7.3% of the energy generated by the portfolio, represented by two assets which have capacity of 55MW between them. A third asset which is in advanced stages of construction is set to be energised before Christmas, adding 9MW of capacity. There are a further 85MW of subsidy-free projects with planning permission, 164MW with planning permission requests submitted, and 481MW at an earlier stage. There are also 43MW of projects in the process of development which will be developed and run for Anglian Water, with the electricity generated to be sold to Anglian Water via a private wire agreement at an agreed price for 25 years.

The portfolio is diversified by geography, equipment manufacturer, subsidy and revenue type, which should reduce specific risks from each factor. Although 95.4% of the portfolio by capacity is in the UK and just 4.6% in Italy, the UK plants are distributed across the country, limiting the chance the weather in any one location could impact the overall capacity. The majority of the portfolio is made up of small plants with less than 5MW of potential (0.6% of the total portfolio output). The managers believe that their proprietary asset management technology allows them to manage these diverse assets effectively, with few of the downsides of managing assets dispersed over a wide area. We believe the continuous historical technical and operational outperformance of NESF's portfolio demonstrates these attractive elements to shareholders.

Fig.2: Portfolio By Installed Capacity



Source: NESF

NESF invests via wholly owned HoldCos. These in turn hold SPVs (again 100% owned) which own the underlying individual assets. This structure allows for preferential rates to be arranged on the gearing. As discussed in the **Gearing section**, debt is taken out at the HoldCo level, with assets assigned to HoldCos depending on the sources of their income, which influences the gearing arrangements that can be made. A potential drawback of this structure could be that if there were a problem with servicing the debt on one of the HoldCos, then income could not be paid out to NESF. However, we understand that there is a considerable margin of error built into the covenants and that it would therefore take extremely low prices for covenants to be breached, especially given the level of subsidy income.

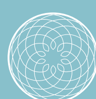
Gearing

NESF's ordinary shares are geared through preference shares. As at 31 March 2020, the company had £200m of preference shares in issue, having issued £100m in November 2018 and a further £100m in August 2019. There is no other fund-level gearing. The preference shares pay a fixed coupon of 4.75% p.a. until March 2036 and do not need to be refinanced for many years. The terms allow NESF to redeem them after 1 April 2030, for the subscription price and any outstanding dividends. If not redeemed by NESF, in March 2036 the preference shares convert into ordinary shares.

Complementing this company-level gearing, NESF invests in assets via five 100%-owned HoldCos. These invest in SPVs which hold the individual assets. Two of the HoldCos have no debt. The remaining three HoldCos are geared through asset-backed loans, with £196m in long-term debt and £18.5m in revolving credit facilities outstanding. The earliest long-term tranche to mature will do so in December 2026.

The weighted average cost of debt excluding the preference shares is 3.4%; including the preference shares, this rises to 4.05%. When taken together, the preference shares and HoldCo gearings represent a look-through gearing level of 42% of GAV (72% of NAV). Whilst high in absolute terms, this is not out of line with peers – indeed, the look-through gearing level is less than the 43% of Foresight Solar Fund (FSFL) and 44% of Bluefield Solar Income Fund (BSIF). Preference shares are classified as a liability under IFRS, although legally they represent share capital. Excluding the preference shares, the financial gearing drops to 22%, which is now considerably less than that of the peer group.

NEC has calculated that the preference shares are significantly more cost-effective for NESF when compared to financial debt, despite the higher interest rate payable,



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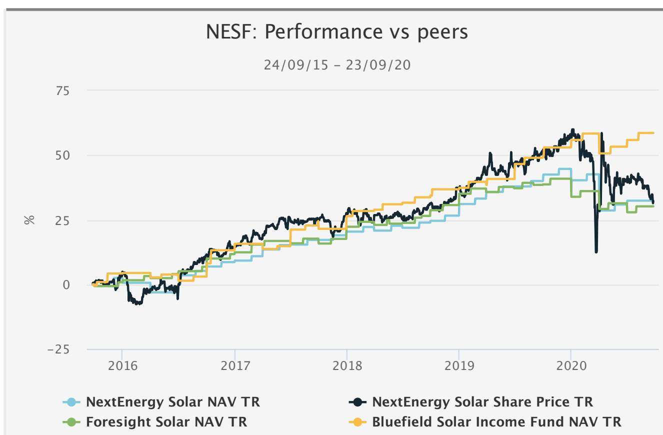
rather than compared to long-term financial debt or a capital raise. As the shares are not amortising, the cash cost each year is limited to the coupon, while the cost of issuance itself is lower at 1.1%. In addition, NESF is under no obligation to repay the principal and it can only be converted into equity in 2036. Finally, the preference shares do not have any security over NESF's assets, unlike traditional financial debtholders.

Performance

NESF publishes its NAV quarterly. Over the five years to June 30 2020 it returned 32.4% in NAV total return terms, according to Morningstar. This compares to returns of 27.9% for Foresight Solar Fund (FSFL) and 55.9% for Bluefield Solar Income Fund (BSIF). As discussed in the **Discount section**, NESF's share price has not recovered much of its losses from the March crash, and the premium has shrunk to 7%.

Fig.3: Five-Year Returns



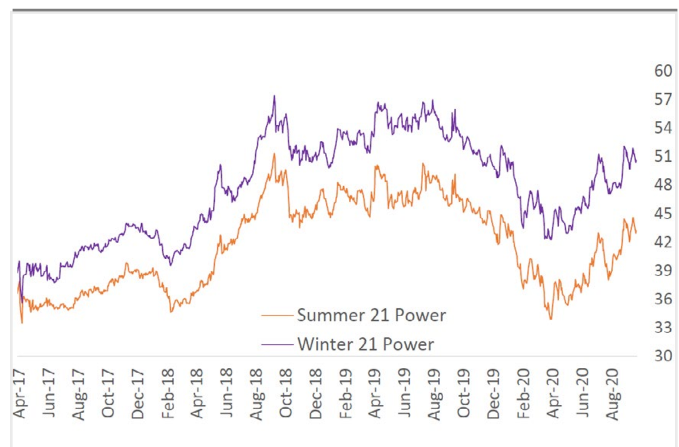
Source: Morningstar

Over the past five years, the weighted average discount rate that NESF uses to value its assets has fallen from 7.5% to 6.8%, while the average life of the assets has risen modestly to 26.9 years from 25.7 years at the end of the 2016 financial year. RPI has grown at close to the 2.5% rate expected in 2016 too. The real headwind has come from falling power prices, which resulted primarily from lower global prices in gas and warmer weather patterns. There has been a steady decline since IPO in 2014, with another leg down following the emergence of the pandemic, which has cut demand for power, leading to falling electricity prices across the forward curve. As NESF relies in part on electricity prices for its revenues, this has reduced its expected cash flows and hence NAV valuations. In fact, in Q1 2020 NESF wrote down its NAV by 7.1pps as a result of lower long-term power price assumptions, and a further 0.6pps in the quarter to June. The NAV is at 98.4p (as at 30/06/2020), meaning it has modestly declined since launch, with all the returns therefore having come from the income (34.4p since launch).

NESF has not been alone in facing these headwinds. The different funds in the peer group all use slightly different power curves which are drawn up by consultants based on their knowledge of the OTC forwards market. Although there may be some small differences in prices at different points, the overall shape of the shift in the assumptions has been the same. Compared to December 2019, in March 2020 the blended curve used by NESF declined on average by 16.9% over the next five years, including a 21.2% reduction over 2020 and 2021, and by a 5% reduction from 2025 until 2050.

However, spot and forward power prices in the UK have increased significantly from their COVID-induced lows in April 2020, and are now approximately 40% higher. This should be beneficial to the NAV in the future by increasing the cash flows available from the assets.

Fig.4: Forward Power Prices



Source: Inenco estimates, NEC

In any case, it is worth emphasising that 63% of the income received is fixed by RPI-linked subsidy. This secured income and the cash dividend cover of 1.2 times (as at March) are both supportive factors behind the dividend, which has been and will continue to be the most important part of NAV total returns.

In our view, although NAV is down slightly since launch this is actually an impressive result given the headwinds the manager has faced. We note the current power price is roughly half what it was expected to be at the time of IPO in 2014. However, through asset management via subsidiary WiseEnergy, NEC has managed to maintain the NAV and pay a cash-covered dividend each year. One of the factors behind this has been the strong asset management alpha added, as discussed in the **Portfolio section**.

We also think it is comforting that the assumptions behind the current NAV are in line with, or more conservative than, the two peers. NESF's weighted average discount rate is 6.8%, in line with that of FSFL, and higher than that of BSIF (at 6%). In fact, looking at BSIF's higher returns, we can

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see they have been boosted significantly in 2020 by the decision to hold the NAV stable thanks to a reduction in the discount rate by 1.2 percentage points (from 7.2% to 6%).

The average life of the assets is 26.9 years, compared to 25.3 years for FSFL and 27.4 for BSIF. We understand that asset life extensions have only been completed on 31 out of the total portfolio of 90 assets (approximately 38% of the portfolio in terms of MW capacity). We also understand that the managers are working on extending a further 12 assets during the current financial year. In our view, the discount rate and the asset life extensions mean that the assumptions underpinning NESF's NAV are reasonably conservative, and certainly not more aggressive than those of peers. Should the rest of the market follow BSIF and move to using a levered discount rate of 6%, then the NAV will (all things being equal) rise significantly.

The table below shows the sensitivity of the three specialist solar trusts' NAV, in percentage terms, to various key factors. NESF has a lower sensitivity to the power price, thanks to its high levels of subsidy income. It has more exposure to RPI than BSIF, although less than FSFL, and its sensitivity to the discount rate and operating costs also lies between that of peers. It is notable that there is a potential 2.1% boost to NAV available by reducing operating costs by a further 10%, which is interesting given the ongoing push to squeeze costs.

Fig.5: Nav Sensitivity (%)

Negative

	NESF (31 March)	FSFL (30 June)	BSIF (30 June)
Discount rate (+/- 0.5%)	-3.3	-5.4	-2.4
Power price (+/- 10%)	-7.3	-9.0	-5.1
Energy generation (+/- 5%)	-7.4	-9.6	-8.3
RPI inflation (+/- 0.5%)	-4.7	-6.2	-3.0
Operating costs (+/- 10%)	-2.2	-3.0	-1.0

Positive

	NESF (31 March)	FSFL (30 June)	BSIF (30 June)
Discount rate (+/- 0.5%)	3.5	5.8	1.6
Power price (+/- 10%)	7.1	9.5	5.0
Energy generation (+/- 5%)	7.2	9.5	8.2
RPI inflation (+/- 0.5%)	5.1	7.0	3.1
Operating costs (+/- 10%)	2.1	3.0	1.0

Source: Company announcements

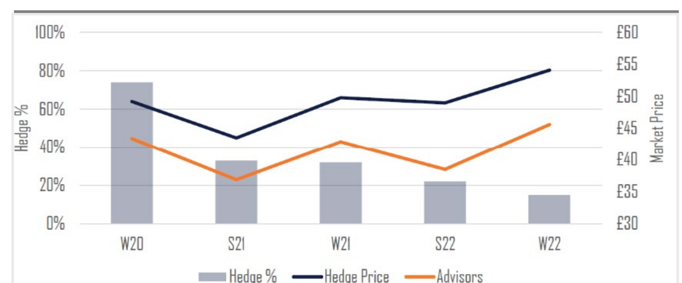
Dividend

The key attraction of NESF from a financial point of view is the high dividend, well covered by the portfolio income, of which a significant amount (see below) is fixed. Dividends are paid quarterly, and on a historical basis last year's dividend of 6.87p amounts to a dividend yield of 6.8% on the current share price. The target dividend of 7.05p for the 2021 financial year implies a prospective dividend yield of 7%. This compares with the dividend yields of peers of 5.9% (Bluefield Solar Income Fund) and 6.7% (Foresight Solar Fund). Historically, the dividend has increased in line with RPI, but given the falling correlation between RPI and power prices and the impact of the pandemic on demand for power, that linkage is under review.

One of the attractions of NESF's income offering is the fixed nature of much of the revenues. At the date of the last annual report in March 2020, 63% of revenues were fixed due to subsidies linked to RPI. Typically NESF fixes additional, varying portions of its electricity sales-related revenues out over the next 18 months by entering into forward power purchase agreements (PPAs). NESF is able to leverage the expertise and activities of the energy sales desk of its asset manager WiseEnergy in order to do this, and we understand other funds do not have access to such activities and expertise.

The manager has secured 74% of its electricity generation for winter 2020/21 (see the graph below). However, given the collapse in the curve after the emergence of the pandemic, the manager left a more significant amount of its generative capacity unhedged beyond winter 2020/21, as can also be seen in the below graph. The manager has been watching the market closely since March 2020, waiting for the right opportunity to hedge. We understand that power prices have been recovering since the start of the pandemic (see the **Performance section**), meaning that in retrospect the manager was right not to fix prices at lower levels.

Fig.6: Fixed Revenues (%)



Source: NEC

NESF's dividend has been consistently covered by cash since launch, at between 1.1 and 1.3 times. This gives the manager headroom to be able to withstand a short period of lower prices and means there is cash available to reinvest in the portfolio if needed. The payout has risen by an average of 2.4% a year, essentially in line with the average growth in RPI over that time.

Investors can opt to receive their dividend in shares. The scrip option allows reinvestment without incurring dealing costs at either NAV or, if the shares are on a premium, then the average of the five days up to and including the ex-dividend date. The board can also amend this formula if it believes it justified. Fractional shares cannot be purchased this way.

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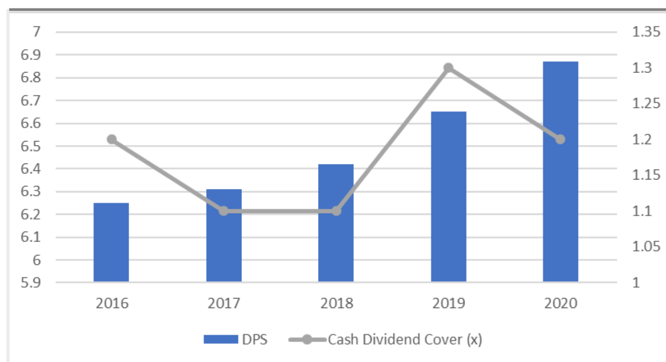
Fig.7: Dividend



Source: NEC

Management

The expertise of the manager is a key selling point for NESF, in particular the integration across what it refers to as "three verticals" – development, asset management and fund management. The fund manager (investment adviser) of NESF is NextEnergy Capital (NEC). NEC was founded in 2007 by Michael Bonte-Friedheim, who previously worked in the European energy and power teams in multiple investment banks, most recently Goldman Sachs. Michael is the CEO, and the CIO is Aldo Beolchini, who joined NEC in 2008 from Morgan Stanley.

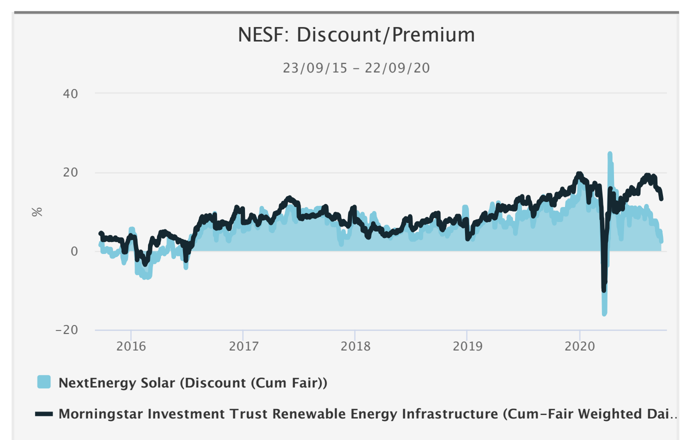
NEC started as a developer of solar power assets in Italy, and has also developed numerous projects in the UK. It manages NESF as well as two private funds, one focussed on Italian assets and one with an international remit hitherto focussed on the US and India. NEC's work as a developer gives it a constant pipeline of projects it can cherry-pick for NESF's portfolio, currently exemplified by a large number of subsidy-free projects which it has under development and is choosing from for NESF.

NEC outsources its asset management operations to WiseEnergy, a wholly owned subsidiary. WiseEnergy was set up in 2008 to manage NEC's assets in Italy, but has branched out into providing asset management for other owners who don't have the ability in-house. WiseEnergy's external clients include notable names such as Actis, InfraRed, Greencoat, Canadian Solar, Partners Group, Solarpack and RTR, and it currently manages a total of 2,300MW (of which NESF manages 755MWp) spread over some 1,500 solar assets. It has developed its own proprietary asset management IT platforms with innovative hard- and software solutions to ensure efficient and effective management of solar plants. NESF thus benefits from its manager's in-depth knowledge of the assets in the market, the issues arising from their construction and the development and ongoing asset management the different developments are likely to allow. We believe a large contributory factor to the excellent alpha-generation track record referred to under **Performance** is this broad footprint in the market.

Discount

NESF sits on a premium of 7%, which we find anomalously small compared to its closest peers, Bluefield Solar Income Fund (BSIF, at 17.7%) and Foresight Solar Fund (FSFL, at 9.2%). As the below graph indicates, NESF's discount was at a similar level to its AIC Renewable Energy Infrastructure peer group until the post-crisis period, since when it has failed to recover to its previous level as its peers have.

Fig.8: Discount



Source: Morningstar

As discussed in the **Portfolio section**, we cannot reconcile this valuation disparity with the facts. Although there is a marginally higher sensitivity to the power price, this is not enough to explain the gap. The gearing levels of all three funds are very similar. NESF's weighted average discount rate is 6.8%, in line with that of FSFL and higher (or more conservative) than that of BSIF (at 6%). As a result, we think that a switch from BSIF or FSFL into NESF makes sense purely on valuation grounds, even before considering the **strengths of the team**, their **alpha generation record** and their outstanding **ESG credentials**. The dividend yield on offer from NESF is superior thanks to this lower rating of the share price.

NESF has traded on a premium since launch, and so the board has not used its buyback authority. It can repurchase up to 14.99% of the shares, so long as this is at a price 5% over the average middle market price over the preceding five days (or at the last independent traded price if that is higher). There is also a continuation vote to be held if the average discount over the financial year is higher than 10%, as long as 75% of votes approve a resolution to hold such a vote. The board also has the authority to issue up to 20% of the ordinary shares, although in 2019 it preferred to issue preference shares to grow the trust, thanks to their lower all-in cost.

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Charges

The ongoing charges figure (OCF) as at March 2020 is 1.1%, below the 1.12% average for the AIC Renewable Energy Infrastructure sector. Its two mature peers, Bluefield Solar Income Fund and Foresight Solar Fund, are both within five basis points, so there is little distinction to be made. NESF pays a management fee on a sliding scale. For net assets up to £200m it is 1%, between £200m and £300m it is 0.9%, and for anything above that it is 0.8%. The management fee is based on NAV so is not paid on the preference shares. The latest KID RIY is 1.8%.

ESG

It is pretty unarguable that investing in solar energy itself brings strong ESG credentials – or environmental credentials at least. NESF's portfolio generated enough electricity in the 2020 financial year to power 185,000 homes, the equivalent of the total electricity required by Aberdeen and Brighton combined over that period, or the same as taking some 220,000 cars off the road for a year. However, the manager, NextEnergy Capital Group, is much more committed to sustainability than this, having integrated ESG goals into all its activities where material. NEC views itself as leading the transition to a more sustainable economy, and its sustainability policy centres not just around climate change but also biodiversity and human rights. Another key feature of the strategy is a commitment to clear and informative reporting, and NESF will report its progress against the UN's sustainable development goals (at least those that have been judged to be material to the trust) in the coming annual report in 2021.

The commitment to reducing emissions which lead to climate change is self-explanatory. As regards biodiversity, NEC has a dedicated team devoted to it who are working with external partners to ensure the impact on flora and fauna is considered fully. We understand that these projects are designed to enhance the biodiversity of the local environment, via adherence to a Universal Biodiversity Management Plan for NESF sites. At the end of March, NESF's sites housed 2.1 hectares of wildflower meadows, with more development pending and a total of 4.8 hectares expected to be in place by this autumn. There were six bug hotels at the locations and another four on the way, as well as seven beehives and three pending. Four hibernacula were also in development, although we note that the covid-19 pandemic has slowed these unfinished projects. We understand the intention is to continue to grow the space allocated to these projects, with an intention to have 30 sites operational in 2021. Early results are already visible: on the wildflower meadows seeded in 2017, the number of plant species has jumped from 20 to 37, the number of bumblebee observations has risen by 500% and the number of butterfly observations by 300%.

NEC is also committed to ensuring human rights are respected at every stage of the value chain involved in its businesses. By the end of 2020, human rights criteria will be added to solar PV contracts, while obligations will be included in contracts to all counterparties. NEC also makes annual contributions of 5% of its profits to the NextEnergy Foundation, an independent charity which aims to reduce carbon emissions, provide clean energy where it isn't available and contribute to alleviating poverty. The last donation was of £50,000 in December 2019, and was used to: provide fuel vouchers to those in poverty in the UK, provide solar power equipment to the Surkhet District of Nepal, and to install a solar water pumping system in the Oromia Region of Ethiopia to increase access to water. In short, we think NESF ticks all the boxes for ESG investors, and should appeal to those who want to put sustainability at the heart of their portfolios.

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