H&G High Conviction Fund
The Markets in Three Charts
September 2021 edition

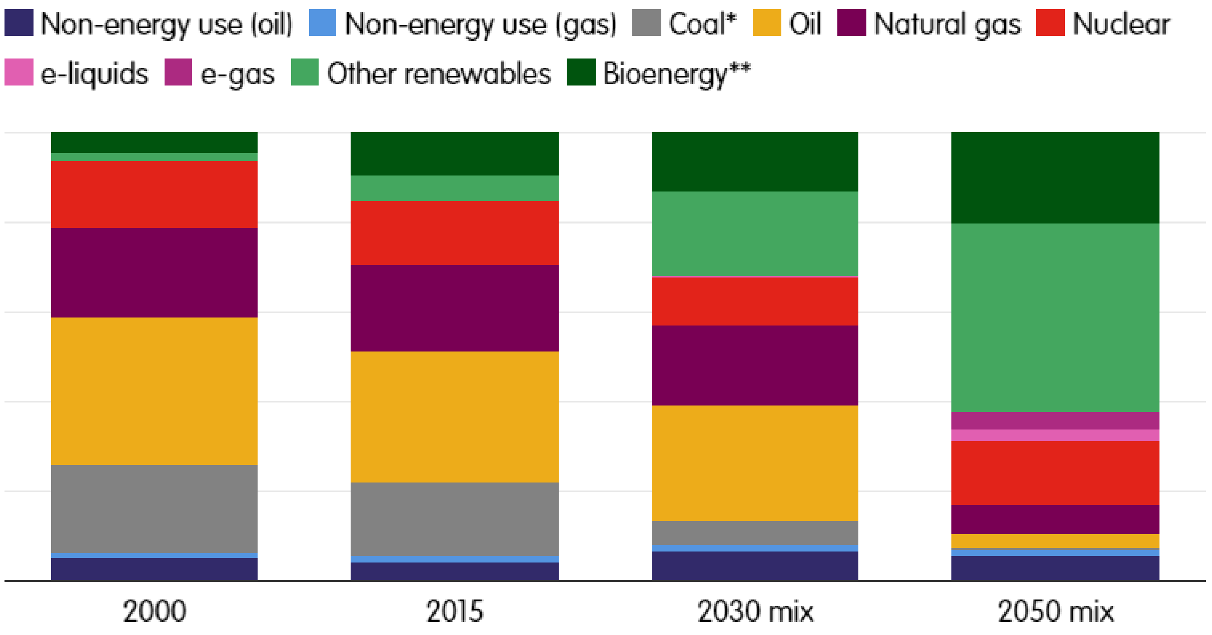
HANCOCK & GORE

Welcome to the first instalment of The Markets in Three Charts, where each month we present some of our current investment thinking in a social, economic and share price chart.

In this edition, we are focusing on the energy market in the EU, since the Fund has a significant holding in Italian natural gas developer Po Valley Energy; further, we believe the EU is a global trendsetter, meaning there could be implications for energy policy in Australia.

Please note we are presenting general insights into our decision making, not investment advice.

CHART 1 – EU energy mix evolution[1]



This bar chart is taken from the EU's Green New Deal, announced on 14 July 2021, which intends to make Europe carbon neutral by 2050 in order to tackle the climate crisis. The obvious trend is the decreasing proportion of fossil fuels in the energy mix, down from 79% in 2000 to 17% forecast in 2050.

Of note is the dramatic decrease in coal from 16% in 2015 to 5% in 2030. Indeed, as at 2020, coal's contribution to EU energy has already fallen by 40% since 2015[2]. In terms of other fossil fuels, oil is expected to fall from 29% in 2015 to 26% in 2030 to 3% in 2050; while natural gas will decrease from 19% in 2015 to 18% in 2030 to 6% in 2050.

The relatively high use of natural gas compared to coal and oil is due to the perception of natural gas as a transition fuel, since it emits 50% less CO2 than coal. Indeed, its expected contribution to EU energy in 2050 is still higher than wind, hydro and solar in 2015.

[1] Retrieved from: https://ecfr.eu/publication/the-geopolitics-of-the-european-green-deal/
[2] Retrieved from: https://ec.europa.eu/eurostat/statistics-explained/index.php?title=Coal_production_and_consumption_statistics

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CHART 2 – Dutch natural gas prices over the last 10 years (US$/mmbtu)[3]

We have used Dutch natural gas futures as a proxy for the EU since they are the most traded futures in the bloc and do not differ substantially to other member countries, including Italy.

As evident, the price of natural gas has soared by 525% over the past year to a multi-decade high. With this spectacular rise, it is no surprise the Financial Times is consistently reporting about a "natural gas crisis". There is an increasing concern about the ramifications of this, including mounting retail electricity prices, the risk that European energy suppliers who have customers on fixed price energy tariffs will go out of business, and the impact on industry due to sky-rocketing energy costs.

What has led to this dramatic rise? Four factors have contributed to a perfect storm. The first is the EU energy transition, outlined above, which has seen a meaningful decrease in coal consumption, and with renewables unable to fully fill the vacuum, a greater reliance on natural gas as a transition fuel. Secondly, energy demand has considerably increased in post-lockdown Europe and Asia, which is the largest consumer of natural gas globally. Thirdly, supply has been limited by the shock of Hurricane Ida as well as Russia curbing exports. Fourthly, there has not been a significant increase in new natural gas projects due to a lack of investment, with funding focused on renewables.

What does the future hold? With global demand for natural gas expected to increase 3% p.a. between now and 2040 and a lack of committed investment in the sector, consultancy Wood Mackenzie has forecast a shortfall of 160 million tonnes of natural gas by 2035[4], which should maintain pressure on prices.

[3] Sourced from Thomson Reuters.
[4] Retrieved from: https://www.bloomberg.com/news/articles/2021-08-06/the-era-of-cheap-natural-gas-ends-as-prices-surge-by-1-000

CHART 3 – Po Valley Energy share price over the last 10 years[5]

H&G High Conviction Fund has 10% of its capital allocated in shares of Po Valley Energy (ASX: PVE). PVE has been a solid contributor to the Fund over the past five years, with an average cost of 1.8c per share, compared to current 2.6c. For full disclosure, the portfolio manager and family personally own PVE shares.

What are the company's assets? PVE's two main assets are natural gas fields in Italy. Both have been successfully drilled. Selva is an onshore field near Bologna and Teodorico an offshore field in the Adriatic. According to an independent valuation in 2019[6], the proven and probable reserves of both fields are worth around 5.6c to PVE (115% above the present share price). Strikingly, this valuation used a natural gas price of US$6/mmbtu which is 75% lower than the current price of US$25/mmbtu, at which the fields could be worth around 50c per share (1,823% above the present share price).

What has driven share price performance over the last 10 years? There is a strong correlation between the European natural gas price (Chart 2) and the PVE share price (Chart 3) for most of the last decade, with both falling from 2013-2016, rising until 2019, and falling in the first half of 2020. However, over the past year, the natural gas price has risen by 525% while PVE's share price has remained flat. We believe this is because the company is not on investors' radars and shares are tightly held, with the top 5 shareholders, including the board and management, owning 60%.

What does the future hold? The company has been progressing through the permitting process for Selva and Teodorico. Business conditions in Italy have dramatically improved since Mario Draghi became Prime Minister in February 2021. PVE received key environmental approvals two months later and expects full permitting by the end of this year with production commencing at Selva in mid-2022. The company is fully funded, with minimal infrastructure required as the well at Selva is 1km from the national grid.

[5] Sourced from Thomson Reuters.
[6] Retrieved from the ASX here.

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FUND INFORMATION

Fund name	H&G High Conviction Fund
Investment Manager	H&G Investment Management Limited
APIR code	SIA0002AU
Fund inception	November 2007 (relaunched April 2021)
Fund size	A$13m
Fund pricing	Monthly
Fund type	Open-end unit trust
Base currency	Australian dollars
Investor eligibility	Wholesale and sophisticated investors
Trustee	Equity Trustees
Custodian	JP Morgan
Auditor	Ernst & Young
Management fee	1% plus GST p.a. + fund costs capped at 1.05%
Performance fee	20% of benchmark outperformance, with a high watermark, paid annually
Benchmark	5% p.a.
Buy/sell spread	0.4%

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