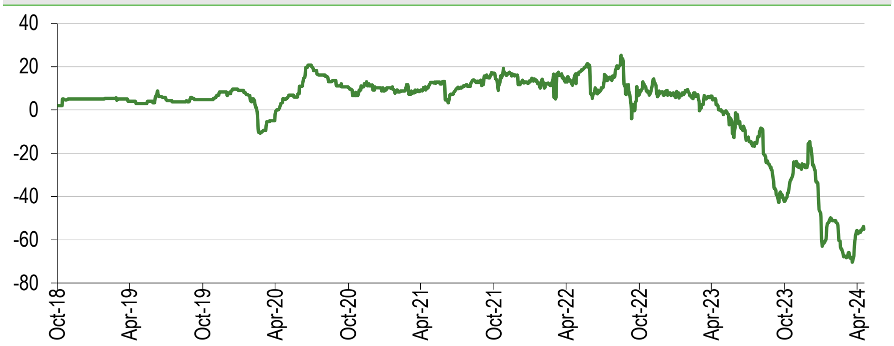
Gresham House Energy Storage Fund

Focused on revenues and project completions

Gresham House Energy Storage Fund (GRID) invests in utility-scale battery energy storage systems (BESS) in Great Britain. GRID and its peers saw sharp share price falls in H223 and early 2024, due mostly to an unexpected decline in revenues and the slower-than-expected utilisation of BESS by the UK's Electricity System Operator (see our last note). In response to these events, GRID's manager, Ben Guest, and its board have refocused the company's use of capital and are now concentrating on maximising cash generation, completing GRID's near-term project pipeline and reducing debt. GRID's revenues have already begun to rise and are expected to improve further as new and extended projects come on line and structural changes within the sector play out. Investors may need to be patient while these measures, and improvements to the National Grid's energy trading platform, take full effect, but the fundamentals of the BESS market are strong, suggesting GRID's longer-term prospects remain positive.

Premium/discount to NAV since inception (%)



Source: LSEG, Edison Investment Research

The analyst's view

- The investment case for BESS rests on the integral role they play in the global transition to renewable energy. Regardless of recent volatility and uncertainty in the UK industry, demand for BESS will grow steadily as the UK strives to meet its net zero target. GRID is positioning itself to reap the full benefit of the opportunities available in this expanding sector.
- Efforts are underway to increase the utilisation of BESS within the National Grid and this will enhance GRID's revenues, as will the company's efforts to increase its operational and trading capacity.
- The decision to cancel the final interim dividend payment for FY23 and suspend dividend payments during FY24 disappointed investors, but the company expects to reinstate fully covered dividend payments in 2025.
- Those focused on sustainable investments may appreciate GRID's contribution to the transition to renewable energy. The company also offers the opportunity to invest in real assets that are often difficult to access.
- GRID's shares are trading at a discount to NAV of more than 50% (see chart above), which may represent a rare opportunity for those who recognise the investment potential of the BESS sector and seek access to the UK's market leader at an especially attractive valuation.

NOT INTENDED FOR PERSONS IN THE EEA

Investment trusts
Renewable energy infrastructure

20 May 2024

Price	**57.8p**
Market cap	**£328.9m**
AUM	**£734.5m**

NAV*		129.07p
Discount to NAV		55.2%
*Including income. As at 30 December 2023.		
Yield*		0.0%
*No FY24 dividend expected.		
Ordinary shares in issue		569.1m
Code/ISIN		GRID/GB00BFX3K770
Primary exchange		LSE
AIC sector		Renewable Energy Infrastructure
52-week high/low	155.8p	38.3p
NAV* high/low	155.6p	95.6p
*Including income.		
Net gearing at 30 December 2023		13.0%

Fund objective

Gresham House Energy Storage Fund seeks to provide investors with an attractive and sustainable dividend over the long term, by investing in a diversified portfolio of utility-scale battery energy storage systems located in the UK and Ireland. In addition, the company seeks to provide investors with capital growth through the reinvestment of net cash generated in excess of the target dividend.

Bull points

- With the share price discount at such extreme levels, now may be a particularly good time to acquire or top-up exposure.
- There is the prospect of capital growth as pipeline projects become operational and are revalued upwards.
- BESS are making a significant contribution to the UK's transition to net zero emissions.

Bear points

- Some investors may be disappointed by the decision to cancel the dividend payments for Q423 and FY24, but the company expects to resume dividend payments in 2025.
- Future trading revenues depend on the successful upgrade of National Grid's trading platform.
- A lack of infrastructure to support the generation and distribution of solar and wind power may slow the UK's transition to renewable energy.

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GRID: Market leader adapting to challenging times

Confronted by revenue challenges

GRID invests in utility-scale BESS in Great Britain. It is the largest UK-listed investment company investing in this market, as measured by operational capacity, commanding a market share of around 20%. The company seeks to capitalise on the intraday imbalances in electricity supply and demand caused by the market's ever-increasing reliance on renewable energy, by accessing multiple revenue sources available in the power market. GRID celebrated its fifth anniversary in November 2023.

The company's performance from inception in November 2018 until 30 June 2023 was strong, delivering an NAV total return of 90% and a share price rise of around 50%. However, conditions in the BESS sector shifted dramatically in the latter half of 2023 and early 2024. GRID and its main UK-listed competitors were adversely affected by a series of challenges to their capacity to generate revenues: a sharp decline in gas prices, a weak electricity market, persistent delays connecting completed projects to the national grid and the slower-than-expected adoption of BESS by the Electricity System Operator (ESO).

The ESO's new electricity trading system is integral to the grid's transition from gas-fired electricity generation to renewable energy, as it will improve the efficiency of the Balancing Mechanism (BM), which balances demand and supply within the market, by drawing on energy sources available at short notice. By their nature, BESS are ideally suited to supply energy in such circumstances, and demand for BESS services was expected to rise markedly once the system was launched in December 2023. However, the system encountered early problems and was shut down for several weeks soon after its launch, frustrating the expectations of GRID's manager, Ben Guest, for an early and significant improvement in trading revenues. In all, the latest available revenue figures show that revenues for the financial year ended 31 December 2023 were £38.7m, down from £62.7m during FY22, while underlying EBITDA for FY23 was £25.8m, down from £48.8m in FY22.

As a result of these developments, GRID and its competitors experienced significant declines in their share prices in H223 and early 2024. GRID's share price dropped by around 70% over this period, although it has since recovered part of this loss (see the Performance section for details).

But conditions have improved recently, lifting revenues

Market conditions began to improve from March, as the ESO increased its BESS utilisation, in part due to the launch of its Balancing Reserve, which opened a new revenue stream for BESS assets. Trading opportunities have also been expanded. The table below illustrates the recent improvement in GRID's total revenues, which the manager considers to be 'promising', although he notes that overall revenues remain below long-term third-party forecasts.

Exhibit 1: BESS portfolio revenue

Month	BESS portfolio revenue* (unaudited and rounded to nearest £100/MW/yr)	Fully operational BESS portfolio revenue** (unaudited and rounded to nearest £100/MW/yr)
January 2024	£40,000/MW/yr	£43,800/MW/yr
February 2024	£37,100/MW/yr	£39,500/MW/yr
March 2024	£47,400/MW/yr	£52,600/MW/yr
1–15 April 2024	£71,100/MW/yr	£77,900/MW/yr

Source: GRID. Notes *BESS portfolio revenue includes all assets that were operational in the period. This includes assets that were in construction, extended commissioning and offline for augmentation works. **Fully operational BESS portfolio category excludes assets in construction, going through extended commissioning, or offline for duration extension works during the period in review. The assets excluded are West Didsbury, Arbroath, Enderby and Nevendon.

Strategic refocus on growth and cash generation

In response to the sharp deterioration in market conditions over recent months, GRID's manager and its board have announced several measures intended to refocus the company's use of capital. They are now concentrating on completing and commissioning the company's existing 2023 project pipeline, increasing the duration of some already operational projects, maximising cash generation and reducing debt. The decision to focus capital on the completion of the near-term pipeline project, which will contribute to earnings in 2024, was announced in January 2024, and once all these projects and duration extensions (shown in Exhibit 2) are finished and connected to the grid, operational capacity is set to rise from 790MW at present to 1,072MW (ie more than 1GW, a significant landmark for the company) by end 2024.

The decision to focus on these near-term projects meant that the previously announced investment in the company's first foreign project, the US-based Project Iliad has been deferred indefinitely. However, GRID's chairman said in the company's recently published annual report that work on the longer-term international and domestic pipeline will be pursued once earnings improve and capital is available.

Exhibit 2: Investment portfolio (as at 17 May 2024)

Existing assets	Location	Capacity* (MW)	Battery size* (MWh)	Site type	Commissioning status	Ownership status
1. Staunch	Staffordshire	20	3	Battery & generators, 0.5MW import	Operational	100% owned
2. Rufford	Nottinghamshire	7	9	Battery & generators, symmetrical	Operational	100% owned
3. Lockleaze	Bristol	15	22	Battery, symmetrical	Operational	100% owned
4. Littlebrook	Kent	8	6	Battery, symmetrical	Operational	100% owned
5. Roundponds	Wiltshire	20	26	Battery & generators, 16MW import	Operational	100% owned
6. Wolverhampton	West Midlands	5	8	Battery, symmetrical	Operational	100% owned
7. Glassenbury	Kent	40	28	Battery, symmetrical	Operational	100% owned
8. Cleator	Cumbria	10	7	Battery, symmetrical	Operational	100% owned
9. Red Scar	Lancashire	49	74	Battery, symmetrical	Operational	100% owned
10. Bloxwich	West Midlands	41	47	Battery, symmetrical	Operational	100% owned
11. Thurcroft	South Yorkshire	50	75	Battery, symmetrical	Operational	100% owned
12. Wickham Market	Suffolk	50	74	Battery, 40MW import	Operational	100% owned
13. Tynemouth	Tyne & Wear	25	17	Battery, symmetrical	Operational	100% owned
14. Glassenbury Extension	Kent	10	10	Battery, symmetrical	Operational	100% owned
15. Nevendon	Basildon	10	7	Battery, symmetrical	Operational	100% owned
16. Port of Tyne	Tyne & Wear	35	28	Battery, symmetrical	Operational	100% owned
17. Byers Brae	West Lothian	30	30	Battery, symmetrical	Operational	100% owned
18. Arbroath	Scotland	35	35	Battery, symmetrical	Operational	100% owned
19. Enderby	Leicestershire	50	50	Battery, symmetrical	Operational	100% owned
20. Stairfoot	North Yorkshire	40	40	Battery, symmetrical	Operational	100% owned
21. Coupar Angus	Scotland	40	40	Battery, symmetrical	Operational	100% owned
22. Grendon 1	Northamptonshire	50	100	Battery, symmetrical	Commissioned July 2023	100% owned
23. West Didsbury	Manchester	50	50	Battery, symmetrical	Commissioned Dec 2023	100% owned
24. York	York	50	76	Battery, symmetrical	Commissioned Jan 2024	100% owned
25. Penworthham	Preston	50	50	Battery, symmetrical	Commissioned May 2024	100% owned
Operational portfolio (A)		**790**	**962**			
Pipeline summary						
Pipeline projects						
26. Melksham	Wiltshire	100	100	Battery, symmetrical	Target Q1 2024	100% owned
27. Bradford West	West Yorkshire	87	174	Battery, symmetrical	Target Q1 2024	100% owned
28. Elland 1	West Yorkshire	50	100	Battery, symmetrical	Target Q2 2024	100% owned
29. Shilton Lane	Scotland	40	80		Target H1 2024	100% owned
30. Duration upgrades	Various	5	328		2024	100% owned
Total operational or under construction		**1,072**	**1,696**			
31. Walpole	Norfolk	100	200		2026	100% owned
Total portfolio owned by the company (pre potential disposals)		**1,172**	**1,896**			

Source: Gresham House Energy Storage Fund. Note: *Capacity in MW is the flow rate of energy, while MWh is battery size (ie storage capacity). A 1MW connection with a 1MWh battery takes one hour to discharge.

In addition to finalising the near-term pipeline, work is underway to increase the duration of several of GRID's already operational projects. Duration extensions increase the amount of time a BESS takes to discharge from full capacity, and hence enhance its potential revenue generation. The planned extensions will lift the duration of the upgraded BESS by up to two hours, from current durations of one hour or less. This is particularly important when trading intraday volatility in power prices, and it is a key consideration for the manager given that trading activity is increasing.

Such extensions to existing projects are also a much faster route to revenue increases than the development of new projects, as all the projects involved are already prepared for duration extensions and do not require new grid connections. They offer a comparable return on investment to greenfield projects and the related cost is relatively low (between £10m and £20m in total, according to the manager). Some of the duration extensions are already complete and when all are upgraded, they should add 5MW to GRID's operational capacity.

However, operational capacity may not quite reach the ultimate level suggested in Exhibit 2, as the manager is considering the disposal of some smaller operational projects, to raise capital and create operational efficiencies. Some negotiations are underway, and further details are expected to be announced over the next month or two.

Dividends expected to be reinstated in 2025

Another key announcement made in January 2024 was the decision not to declare a final dividend for FY23, and to review GRID's dividend policy for 2024 and beyond. In a subsequent trading update in April 2024, GRID announced that it would suspend dividend payments for 2024. Guest explained that the basis for this move was that commissioning the company's existing 2023 pipeline projects provides a better return on available capital than dividend payments (or the share buyback programme implemented in February 2024). However, the company aims to reinstate fully covered dividend payments in 2025.

The decision to cancel the Q423 dividend means that shareholders received three interim dividends each of 1.84p, in respect of the first three quarters of the FY23. The last of these was paid in December 2023, and means the total dividend payment for the year was 5.51p, rather than the 7.35p previous foreshadowed. This compares with dividend payments of 7.0p per share paid in each of the three previous financial years.

Debt facility reduced

The decision to redirect cash away from dividend payments also allowed GRID to cancel £110m of debt commitments that are surplus to requirements. This will reduce the facility to £225m, more than sufficient to fund the completion of the existing pipeline. Associated fees could be reduced to around half their previous level.

GRID manager and board confident about the longer term

GRID's manager and its board insist that the prospects of the BESS industry, and GRID, remain positive. In the near term, the projected increase in GRID's operational capacity, combined with other developments within the BESS sector, lead GRID's manager to expect revenues to continue to rise over the remainder of this year. According to Guest, the new and extended projects have the potential to 'approximately double' the earnings capacity of the portfolio, compared to FY23 revenues. Once commissioned, these projects will also be revalued, lifting GRID's NAV (see the Performance section for further discussion).

Trading revenues should also continue to rise as the ESO's automated trading platform becomes fully operational in 2027, and trading opportunities for BESS increase accordingly. The company is therefore in the process of moving its non-BM assets into the BM to capture these greater revenue opportunities as they become available. (Half of GRID's operational BESS portfolio was registered in the BM (as at 23 April 2024), and more projects may be registered as value emerges.)

GRID's is also set to benefit from some longer-term developments. The general move towards renewable energy is inexorable, as the UK pursues its net zero carbon emissions target. And the country's need for battery storage capacity will continue to increase, given the rising levels of renewable generation coming online. It is estimated that renewables will meet 70% of UK demand by 2027, up from 45% today, increasing the need for the flexible generation BESS provide.

Performance: Hit by lower revenues and system issues

Exhibit 3: Five-year discrete performance data

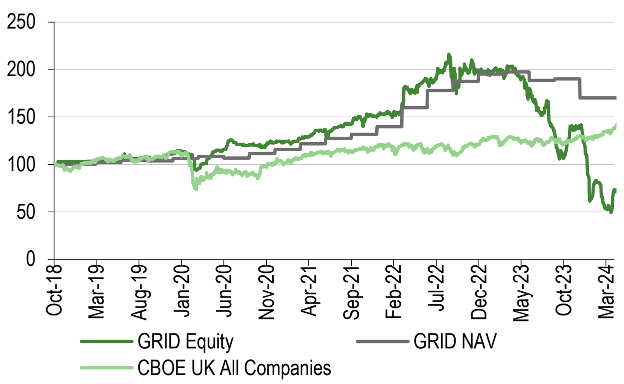
12 months ending	Total share price return (%)	Total NAV return (%)	CBOE UK All Companies (%)	MSCI World High Dividend Yield Index (%)	World Renewable Energy Index (%)
30/04/20	(0.1)	6.2	(17.2)	(7.0)	39.1
30/04/21	24.7	12.5	25.3	13.4	124.8
30/04/22	36.2	31.2	9.1	11.0	(7.5)
30/04/23	15.4	23.5	7.0	(1.2)	(5.1)
30/04/24	(64.0)	(3.8)	7.4	5.5	(30.2)

Source: LSEG. Note: All % on a total return basis in pounds sterling. NAV return based on end December 2023 NAV, the latest available.

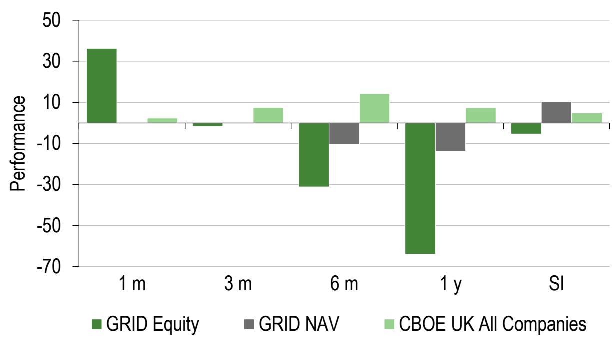
Recent events have had an inevitable impact on GRID's performance. The company publishes its NAV once a quarter, and the latest available NAV is for the financial year ended 31 December 2023. At that date, GRID's NAV stood at 129.07p per share, down 11.6% from the NAV of 146.08p at end-Q323 and 17.0% lower that the NAV of 155.51p at end FY22. This decline over the past year reflects several factors, most notably the fall in third-party revenue forecasts, which adversely affects project valuations, along with weak revenues from operational projects over the period. In addition, the manager has made further cuts to revenue assumptions for the period covering 2024 to 2026, while the payment of a partially uncovered dividend for FY23 also had an adverse impact. However, the NAV did receive some partially offsetting support from other factors, including upward valuations to new projects as they became operational. Site upgrades also contributed, as did a significant number of additional Capacity Market 12-month contracts, which began on 1 October 2022. Increases in estimated inflation rates also supported the NAV over the period.

Exhibit 4: Investment trust performance to 30 April 2024

Price, NAV and benchmark total return performance, since inception rebased (%)



Price, NAV and benchmark total return performance (%) *



Source: LSEG, Edison Investment Research. Note: *All NAV performance calculations use end-December 2023 NAV, the latest figure currently available. One-year, three-year and since inception performance figures are annualised.

While GRID does not have a formal benchmark and its assets are very different from conventional financial instruments, it is nonetheless of some interest to compare the fund's performance to the broader UK market. Exhibit 4 uses the CBOE UK All Companies Index as a proxy for the UK market. It shows that while events over the past year adversely affected GRID's relative performance, the company has outperformed the UK market in NAV terms since inception. (As the Q124 NAV is not yet available, the NAV performance calculations in Exhibit 4 use the end-December 2023 NAV.)

The near-term revenue environment, and GRID's revenue outlook, remain uncertain, but we can be confident that the company's NAV will be subject to some positive influences over 2024. Its Q124 NAV is set to benefit from some new revenue contracts, and the share buybacks undertaken between February and April 2024 are accretive to the NAV. As mentioned above, the upward valuations of pipeline projects as they are commissioned will also lift the NAV over coming months.

Discount may present an opportunity to invest at a low price

GRID's shares usually trade at a premium to cum-income NAV (see chart at the start of the note), but the sharp share price drop over the past six months or so has seen the share price tumble deep into discount territory. The discount reached its widest reading of more than 60% in February 2023, at which point the company initiated a programme of share buybacks to support the share price. These continued until mid-April 2023, after which the company decided to redirect capital to the development of its project pipeline, as discussed above.

These buybacks, combined with the recent improvement in revenues, have, arguably, provided support for the share price. It is also likely that investors have begun to see value in the shares, which one analyst estimates are now trading below the replacement cost of GRID's BESS assets. GRID's discount narrowed to around 50% in recent weeks.

For those who share the confidence of GRID's manager and board in the long-term viability of the battery storage industry and the company's prospects, the sharp decline in the company's share price may provide an opportunity to invest at an unusually low price. It may take some time for conditions in the sector to normalise, and for GRID's revenues to fully recover from recent events, but as and when they do, the company's share price discount has scope to narrow back towards its historical levels.

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