Davis ADVISORS

Uncovering Value in Clean Energy Today: From Biofuels to Electrification

A Conversation with the Davis Research Team

Key Takeaways

- The secular shift to clean energy has been occurring for years, but is still in the early innings. We're putting the mosaic together to find compelling long-term opportunities.
- Cleaner energy requires more electrification, which requires more copper. Finding attractive ways to invest in copper requires looking beyond the overvalued pure plays.
- Biofuels and sustainable aviation fuel are the next frontiers in cleaner energy.
- We expect that electrification, which extends well-beyond the automotive industry, will create opportunities for long-term investors.

Perspectives on the Shift to Cleaner Energy

Chris Davis: There are trends like electrification or artificial intelligence that have been in place for a long time, but all of a sudden become a centerpiece of investor awareness. There has been a general sense that the trend was going to be a big deal in the future, but somehow markets weren't that concerned about it until, all of a sudden, it's in the headlines.

I like this observation by Bill Gates, who said, "In the short term, true disruptive innovation gets significantly overhyped, but in the long term, it gets significantly underestimated." And so we're somewhere in that phase right now around both electrification and AI. They're topics that cut very broadly across all sorts of different businesses.

Danton Goei: A secular shift to cleaner energy has been happening for quite a while now, and will probably continue for a very long time. The move from fossil fuels to cleaner renewable energies is going to impact all kinds of existing industries as well as create entirely new industries. It'll also require different sorts of supplies and raw materials. We've been really keen on trying to identify all the pieces in this transition and put the mosaic together.

Copper Plays a Critical Role in the Energy Transition

Darin Prozes: I think collectively we are all struggling to find ways to continue to lead the lives that we want to lead while decarbonizing. We've seen very interesting transitions happening in how we use energy and in what energy sources we're tapping. When you're in the midst of a big secular trend like this, the challenge is trying to separate what is hype from what is reality. We do think that this is a trend that has staying power, but as valuation-sensitive, long-term investors we think it's important to pick our spots. We're interested in finding companies that have sufficient durability to their businesses, and those that have a moat.

One area that's interesting is the trend to electrify both transport and buildings. Copper has a wonderful underlying growth aspect to it because nearly every

solution for the decarbonization problem involves more electrification, which involves more copper. We own a company called Teck Resources, which is a Canadian mining company. They have a nice portfolio of producing copper mines and about-to-be in production copper mines, and a nice growth portfolio as well. It's a company with a substantial family insider ownership, and good priorities.

The interesting thing about copper is that demand is inflecting very fast. While consumption has been rising steadily since the early 1990s it is projected to accelerate markedly in the coming decade as investments to meet lower emissions targets are made and developing countries continue to industrialize. On the demand front, for example, electric vehicles are still a small share of car sales but they're growing fast. The typical EV uses three to four times as much copper as the typical internal combustion engine car. Renewables, such as solar and wind sources, are also heavily copper-intensive. We see buildings being increasingly electrified and that requires more copper intensity too.

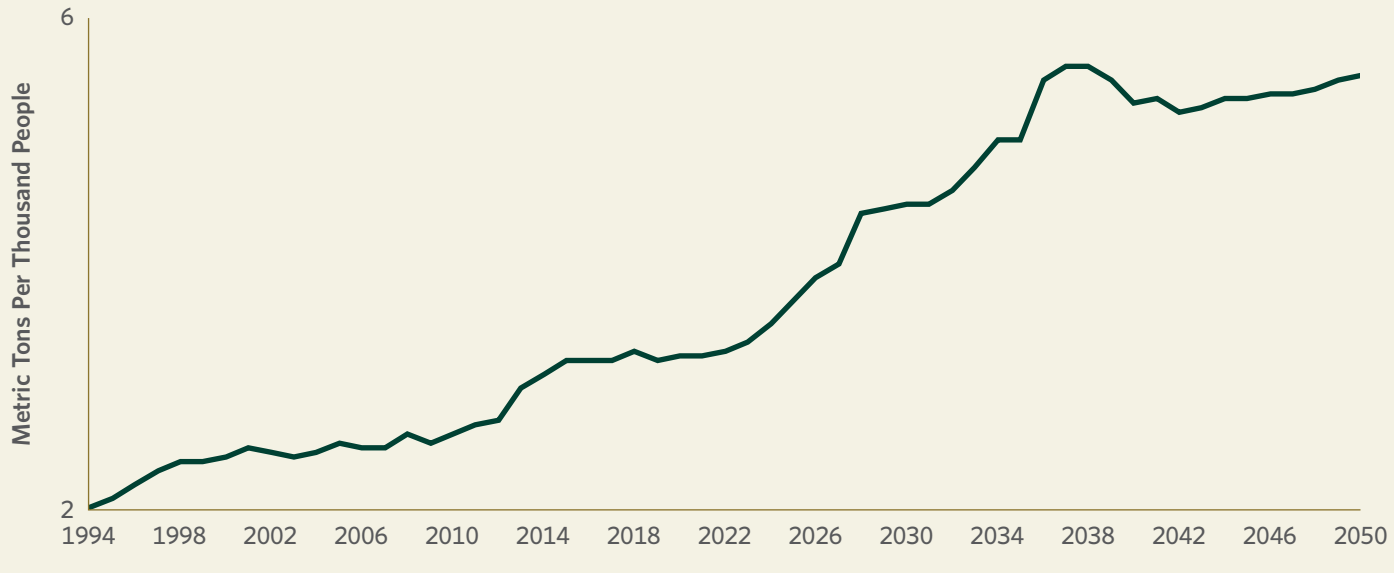
It takes a very long time for a copper mine to come on stream—10-plus years—and there's a mismatch between the level of demand and how fast they can actually bring new copper to the market. We think that's a really interesting trend. Teck's a good example of a company that we think has nice control of this choke point, and that is valuable.

Danton: The supply and demand dynamics in copper are quite a bit different to most other commodities. Certainly on the supply side, just how long it takes sometimes for the supply to come online makes a big difference.

We do have a variety of holdings that circle around and benefit from some of these energy transition tailwinds. For instance, we own two of the best low-voltage electrical equipment manufacturers, Eaton and Schneider. Both are wonderful businesses with strong distribution moats and attractive margins. Each time someone puts in solar or an EV charger, for instance,

Demand for Copper Will Accelerate in the Coming Decade[1]

Global Refined Copper Consumption Per Capita



1. Source: International Copper Study Group (ICSG), S&P Global.

there's an electrical upgrade that comes with it, and often Eaton and Schneider are the equipment brands involved behind the scenes. Owens Corning is another one—they produce building insulation that has a great energy payback.

Biofuels and Sustainable Aviation Fuel—The Next Frontiers in Cleaner Energy

Darin: Biofuels is another area we're spending a lot of time on, and find very interesting. We own a unique company called Darling Ingredients which has a wonderful moat. They have about a 15% global share of the rendering business. Darling is essentially taking all the waste products from animals after the meat is used for human consumption and repurposing it for a variety of end uses, including fertilizers, pet food, animal feed, and the like.

Darling has also found an economic way to make biofuels out of waste. Along with their JV partner, Valero, they're the largest producer in the U.S. of a product called renewable diesel. It's just like regular diesel but is 60–80% less carbon-intensive than oil out of the ground. They derive it from waste products from our food supply, including cooking oil, and have a business devoted to collecting used cooking oil from restaurants.

Their next product is going to be sustainable aviation fuel. In the aerospace industry, where we've historically done a fair bit of work in, there are no obvious solutions for energy transition and decarbonization. People talk about electric and hydrogen as possibilities, and they're certainly pushing the ball down the field on these technologies, but it's very hard to make the economics work, given the weight and safety requirements of an airplane.

Darling is going to repurpose some of their capacity to make sustainable aviation fuel, which would allow the airlines to get credit for decarbonizing some of their fuel supply. Airlines are very eager to buy this fuel, and they've already stepped up and made commitments to blend a certain percentage of this fuel into their jet fuel purchases over time. We think Darling is in a great position to be able to take advantage of this.

Transportation Is the Tip of the Iceberg for Electrification

Chris: This topic brings me back to 10 years ago when our team was on a guided tour of a Texas Instruments lab with the CEO at the time. An entire wing of the lab was dedicated to engineers developing digital motors, which weren't really that prevalent in the market at the time. Digital motors weigh a fraction of mechanical motors, and are far more reliable. Texas Instruments said, "This is going to be the next big deal."

Transportation is the tip of the iceberg for electrification. We're focused on it because it's directly impactful in our lives, whether we buy a traditional combustion engine or an electric vehicle. But very much under the surface there are dozens of devices in your daily life that have become electrified without you knowing it. We think there are great investment opportunities to be uncovered as electrification continues to become more widespread, and go well beyond the automotive industry.

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Item #4700 12/23