Pedagogical Notes | MIPC 2019

Axe Capital | National University of Singapore

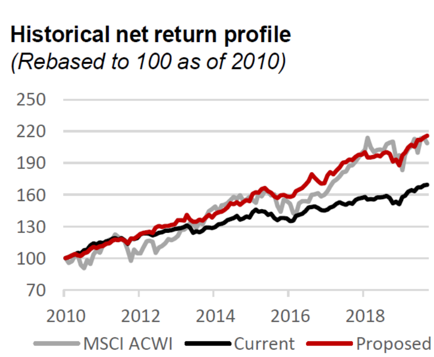
Proposal at a Glance

Axe Capital's proposal aims to reduce NLPIB's reliance on the oil and gas (O&G) industry while encouraging long-term sustainable investments. With most of its income coming from O&G, the fund is exposed to the associated financial and market risks. Moreover, key stakeholders, including activists and the indigenous communities, are pushing for more sustainable and safer practices in NL's O&G industry while demanding one of its largest investors to invest with greater environmental stewardship in mind.

Unlike other winning proposals, Axe provides a chronological solution divided into three stages: 1) short-term portfolio rebalancing, 2) medium-term divestment of its stake in South White Rose (SWR), 3) long-term investment in a greenfield wind farm. Axe's proposal battles climate change by reducing NLPIB's overreliance on O&G, while improving the fund's risk-adjusted return and NL's economic growth.

Short-Term: Portfolio Rebalancing (< 1 year)

The short-term strategy consists of improving risk-adjusted returns while reducing fund exposure to O&G through indirect investments. Since the ETFs with O&G exposure represent a long-term risk to the portfolio, Axe proposes re-investing them instead in more ESG-focused ETFs and decreasing O&G investments from 16% to 14% of AUM. Additionally, the current asset allocation underperformed historically, so this strategy also aims at achieving mandated returns. The proposed asset allocation increases the portfolio return while decreasing its risk exposure. Overall returns are projected to increase from 5.4% to 7.13%, and the 1-year, $100M value at risk decreased from 11.3% to 8.5%. Finally, a 27% increase in Sharpe ratio to 0.96 further highlights an improvement in adjusted returns, as seen below:



The rebalanced portfolio not only provides higher returns, but also emphasizes ESG-focused holdings to alleviate the concerns of pro-divestment stakeholders. This solution removes concentration in Canadian assets through greater exposure to global corporate bonds and hedges against market downturns via infrastructure indices. Finally, Axe proposes a unique component of its short-term strategy: a public statement to specifically highlight the $300 million divestment and improved return profile, as well as NLPIB's future goals in sustainable investments.

Medium-Term: Partial Divestment of SWR (~5 years)

The medium-term strategy would decrease NLPIB's stake in SWR by 35% and reinvest proceeds into real assets in the renewables sector, reducing the fund's total O&G investments from 14% to 10% of portfolio. This strategy further demonstrates that NLPIB can achieve higher returns with lowered exposure to O&G. The $58M stake will be sold at a higher value and hedge NLPIB against the ultimate obsolescence of O&G, but the remaining holdings allow the fund to monitor the environmental impact of SWR's actions.

The fund should sell its stake to an environmentally conscious buyer, and Axe has considered three groups: companies with operations in the same oil basin, global oil majors interested in NL, and energy-focused private equity (PE) funds. Local oil companies control most adjacent oil fields, and thus would profit from operational synergies due to their proximity to SWR. As for the foreign entities and PE funds, they could consider expansion into the oil-rich province. Axe recommends selling to local companies, as they are most likely the highest bidders who desire the mentioned synergies and are more familiar with NL's environmental laws and stakeholder groups.

There are two risks involved in this sale. NLPIB might not find a buyer, which could be mitigated via lower valuation for SWR. Secondly, the buyer, if found, might not be as environmentally friendly as the fund, but NL laws should mitigate this risk as they are now strictly enforced after the Sea Rose oil spill.

The second part of this strategy consists of re-investing proceeds from the SWR sale into renewables, which have declining costs and rising demand. Axe suggests investing in a basket of companies, composed of three regional renewables developers with dominant local power generation and three international manufacturers of solar panels, wind turbines, and electric vehicle batteries respectively. The investments allow NLPIB to capitalize on the increasing popularity of renewables and expand its investments' geographical reach. This strategy not only diversifies NLPIB's income streams while increasing cash flow from sustainable sources, but also further demonstrates the fund's ESG commitment to board members and key stakeholders.

Long-Term: Greenfield Wind Farm (> 10 years)

The long-term strategy aims at increasing NLPIB's direct investments in NL assets from 23% to 25%, which should help trigger the province's economic growth. Moreover, a real asset such as a greenfield wind farm would provide strong returns and exemplify adherence to ESG principles. Despite not being as profitable as divestment from O&G holdings, the wind farm will push the fund portfolio's return above its minimum requirement and eliminate its reliance on the O&G sector. More importantly, NL has the capacity to produce 16 times more wind energy than it consumes, indicating huge potential for the province to become a strong offshore wind exporter and garner higher profits from declining costs of energy-storing battery packs. Regarding the project financing structure, Axe proposes either 100% equity, which provides an annual return of 7.6%, or 50% debt and equity, which increases the return to 11.5% and aligns better with NLPIB's other direct investments. Lastly, the fund should protect the project's rate of return by carefully managing project costs within budget and securing power purchase agreements.

Axe has recognized the risks associated with such an investment. Firstly, there exists legislations that could limit its short-term growth, but the team is confident that presenting a strong business case would influence the government to update regulations accordingly. Secondly, the returns are highly dependent on wind energy purchase price, as a 10% price decrease would cut IRR by 1.5%. Nonetheless, this asset diversifies income streams from O&G to clean energy and strengthens NL's economic and environmental sustainability.

Stakeholder Analysis

After a partial divestment from SWR, the **NL government**, currently trapped between a budget deficit and its environmental mandate, will benefit from continued tax revenues and offshore royalties in the O&G sector. With sufficient government funding, **taxpayers** can also continue enjoying social services and new future investments in renewables.

Meanwhile, all **pensioners** will receive equal benefits, since NLPIB will not be underfunded under Axe's proposal to create more stable returns. Thus, NLPIB will still fulfil its fiduciary duties despite lower reliance on the lucrative O&G sector. Nonetheless, **indigenous groups** will not be entirely satisfied by the short-term strategy, but the SWR divestment and transition to clean energy should placate them temporarily.

As for the **O&G Labor Union**, they will undoubtedly benefit from a partial, rather than complete, divestment from SWR. Most O&G workers will retain employment and can seek opportunities in other sectors as divestment is gradually completed. Lastly, **environmental activists** will be satisfied by NLPIB's commitment to more sustainable investments and better management of SWR.

Final Considerations

Axe provides a comprehensive three-stage approach that distinguishes itself from other winning teams. The short-term rebalancing of indirect investments would yield higher risk-adjusted returns. In the medium-term, the partially SWR divestment and subsequent re-investment of proceeds in renewables would address environmental concerns. Finally, the long-term construction of a wind farm helps NLPIB to catch the new wave of renewable energy in NL. By gradually reallocating assets from oil extraction to renewable energy, NLPIB prioritizes long-term sustainability over short-term profit and satisfies various stakeholders. Most importantly, the fund meets both parts of its dual mandate: the required return of pensioners and the sustainability of the NL economy.