Nearshoring – The Friend Next Door

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Sometimes in life, you might hear a saying and laugh at the simplicity of the statement itself. Other times, you will be in a situation, and that same *saying* will ring truer than it ever has. The saying in this matter is, "If it ain't broke, don't fix it."

Throughout the COVID-19 pandemic, we heard management teams from major companies talk about supply chain constraints, bottlenecks, and all the lingo used to summarize, "our supply chain is broken, and it needs fixing." This is where the concept of *nearshoring* comes into play as a solution to the supply chain issues brought on by the pandemic.

Nearshoring is the process in which organizations and businesses take deliberate action to strengthen their supply chains while also reducing exposure and interdependence on other countries to some degree, which in turn can reduce geopolitical risk. From a North American perspective, many industries and sectors are poised to benefit from the transition to a closer and more resilient value chain. Canada, Mexico, and the United States offer synergies and complementary resources to each other, such as capital, markets, raw materials, and labor. Couple this with significant fiscal support from the United States government via the *CHIPS and Science Act* and the *Inflation Reduction Act (IRA)*, and we see a significant amount of cash flow crossing borders that benefits from United States-Mexico-Canada Agreement ("USMCA") working together in unison.

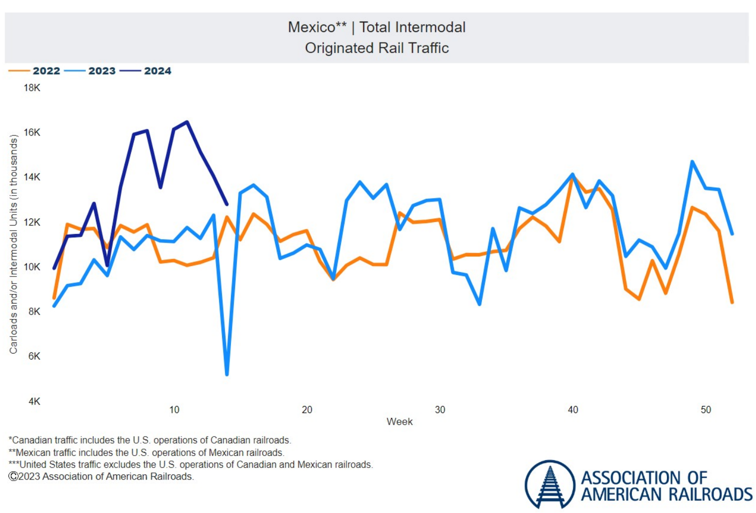
Nearshoring presents an exciting opportunity from a transportation point of view, specifically, with the railways which are currently held in our BCV model investment strategies: **Canadian Pacific Kansas City Limited** ("CPKC" - formerly Canadian Pacific Railway Limited), **Canadian National Railway** ("CNR"), and **Union Pacific Corporation** ("UNP"). All three BCV model names have taken significant action, which is poised to benefit from the nearshoring theme. CPKC's purchase of Kansas City Southern cleared its final regulatory hurdle in early 2023, which created the first and only single-line railroad that connects Canada, the United States, and Mexico.

Source: CP Investor Day Presentation - June 2023 - Slide 8

Not long after CPKC's announcement, Canadian National Railway, Union Pacific Railroad, and Grupo México Transportes created an attractive partnership to service current and prospective clients to provide a competitive proposition, while also benefiting from the nearshoring tailwinds.

Source: CN Website - Falcon Premium Intermodal

We have seen confirmation of this theme, with a publication shared via FreightWaves stating Mexico's two largest Pacific Coast ports, Manzanillo and Lazaro Cardenas, reporting record container movements in January 2024, with Manzanillo increasing 13.8% year over year and Lazaro Cardenas increasing 40% year over year (FreightWaves, 2024). While also utilizing Rail Traffic Data provided by the Association of American Railroads, we can see a strong upward spike in the early weeks of 2024 for Mexican Intermodal rail traffic.



Source: Association of American Railroads Rail Traffic Data

In conclusion, freight railroads are considered the backbone of the North American economy, with their reach into nearly all areas of the economy, directly and indirectly. They possess an irreplaceable infrastructure and transport goods four times more fuel efficiently than truck traffic. The railroads can transport one ton of freight nearly 500 miles per gallon of fuel, on average. CPKC, CNR, and UNP all possess strong management teams, with unique advantages and opportunities that can allow all three business to succeed. Add in the tailwind of nearshoring, and these businesses have a legitimate opportunity to succeed and continue driving shareholder value at a significant rate.

Additional Source
Focus On Nearshoring: A Multi-Year Transformational Opportunity for North America
(Link to Report)

The Next Era of Energy

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The deployment of renewable energy continues to accelerate as global power demand grows, and governments intensify efforts to reduce global carbon emissions. According to the Energy Information Administration (EIA), renewable energy is expected to increase from approximately 30% of total global power production in 2023 to 50% by 2030. While the long-term growth outlook for the renewable sector is robust, the sector has come under pressure as a result of rising interest rates and supply chain inflation. These macro factors have presented challenges for these businesses; however, we believe that the long-term growth outlook and relative valuation metrics in the sector are attractive. Two businesses within BCV's North American Equity portfolio that operate within the renewables sector are Northland Power (TSE:NPI), and NextEra Energy (NYSE:NEE).

Northland Power

Northland Power is a Canadian power producer with a focus in global offshore wind development. The company has 3.4 gigawatts (GW) of generating capacity in operation, and currently has 2.4 GW under development. The company has two major offshore wind development projects: the 1.1 GW Baltic Power project in Poland, and the 1.0 GW Hai Long project in Taiwan. While these projects have been impacted by supply chain inflation and higher interest rates, we were pleased by final outcomes delivered at financial close for both projects, and feel the company is well positioned to execute on construction over the course of the next several years.

Northland Power announced the financial close of Baltic Power in September of 2023. On financial close, financing and supplier contracts were secured, marking a significant de-risking event for the project and the company. While the total project costs came in above the company's original $5-6 billion estimate, the long-term project returns are expected to be attractive. The $6.5 billion project has a 25-year revenue contract-term, including an inflation indexation feature which should provide offsetting benefits to higher inflationary price pressures. When complete, the project is expected to generate $300-320 million in adjusted earnings before interest, tax, depreciation and amortization (EBITDA), and we anticipate it will deliver long-term project percentage returns in the low teens. Fabrication of foundations and offshore substations has commenced, in addition to construction of the onshore substations. Commissioning is expected to start in the first quarter of 2026 with the full wind farm finalized by the second quarter of 2026.

In addition to Baltic Power, Northland Power announced financial close of Hai Long in September of 2023. This was another significant de-risking milestone for the company as financing was secured at all-in interest cost of 5%, and a prior agreement with Gentari Renewables for a 49% equity interest sell-down closed in December. The company was able to negotiate an amendment for the project corporate power purchase agreement (CPPA), extending the contract by eight years for a total contract period of 30 years. The $9 billion project is expected to generate $230-250 million in adjusted EBITDA, and we anticipate will deliver high single digit percentage long term project returns. Construction has commenced, and the company is anticipating reaching first power and the commencement of pre-completion revenues in the second half of 2025.

Despite a challenging operating environment, we have been encouraged by Northland Power's ability to effectively navigate and secure the economics for both Baltic & Hai Long. We believe that the company's experience in large project construction bodes well for the timelines communicated for both projects. As the company executes on project construction, we feel that market may begin to appreciate the attractive growth outlook for the business. The company is guiding for a 7-10% EBITDA compounded annual growth rate through to 2027, and trades at what we believe is an attractive valuation.

NextEra

NextEra Energy is the world's largest producer of renewable energy and is based out of Florida. The company's two primary business segments are Florida Power & Light (FPL) which is a state regulated utility, and NextEra Energy Resources (NEER) which is a clean energy business focused on development and operation of renewables assets in the United States and Canada. NEER currently has a generating capacity of 36GW predominantly in wind (24GW) and solar (7GW).

One of the key elements of the United States Inflation Reduction Act (IRA) is roughly $370 billion in green energy spending, alongside tax credits and incentives to help drive renewable energy investment. Production tax credits are expected to remain in place until such time that carbon emissions drop to at least 75% of 2022 levels, allowing for a long growth runway for businesses like NextEra. We believe that NextEra is uniquely positioned to take advantage of these tax credits as the company moves forward with their 20GW renewables backlog. While it is difficult to quantify the expected financial tailwind of the IRA, the company anticipates project level returns of approximately 15% on solar assets and approximately 20% on wind and energy storage.

With a strong balance sheet, attractive demand profile, and unparalleled scale providing for strong buying power among suppliers, we believe that the long-term growth outlook for NEER is attractive. Combined with their premier state regulated utility at FPL, NextEra is guiding for 6-8% adjusted earnings per share growth from 2024-2026. Management has suggested that they would be disappointed if they were unable to execute at the high range of their guidance.

As we observe this transformational shift in global power production, we believe that both Northland Power and NextEra Energy stand to benefit from this secular transformation. With Northland Power's extensive offshore wind experience, and NextEra Energy's unparalleled scale and first mover advantage, we feel that both of these businesses are well positioned to participate in this energy transition, and deliver attractive shareholder returns.