

Energy efficiency markets; conf. call highlights

We recently hosted a conference call to discuss trends in the Energy Efficiency markets. The discussion featured: Jeremy Eaton (Vice President, Honeywell Energy Solutions), Richard Graber (Vice President, Honeywell Government Relations for EMEA), and Bill Livingood from the Commercial Buildings Research Group at the National Renewable Energy Lab ("NREL").

The Energy Efficiency industry encompasses both product suppliers (e.g., manufacturers of thermostats) and enterprise building integrators. **Overall, volatile and high energy prices, coupled with tightening regulation around emissions, are expanding the market opportunities for a variety of industrial companies, including Honeywell.**

In the US, buildings consume 40% of the country's power (split roughly 55% residential/45% commercial). On the residential side, the biggest use of electricity is for heating (>30% of total electricity usage) whereas in commercial markets, the biggest use of electricity is for lighting (>25% of total consumption). Honeywell estimates that building automation tools can control/lower nearly two-thirds of the energy use in homes and buildings.

Roughly 60% of Honeywell's nearly \$16bn Automation & Control Solutions (ACS) segment is linked to Energy Efficiency. Honeywell ACS products and services enable building owners and end users to optimize efficiency. Our discussion focused on Honeywell's \$1bn Energy Solutions business that is housed within Honeywell Building Solutions: ~\$600mm of Energy Performance Contracting, ~\$200mm from Energy Services (non-guaranteed energy projects, energy-related services), and ~\$200mm from Utility/Smart grid.

NREL sees continuous energy efficient controls potentially providing 5% to 20% in annual energy savings. Identifying these one-time measures and applications for new buildings and retrofits can be discovered via energy audits. By installing controls, sensors and diagnostic systems throughout a facility, a facility manager/operations center can identify anomalies and inefficient patterns of energy use.

The market for energy management services companies (ESCOs) was estimated to be more than \$20bn in 2009 and is expected to grow at a compounded rate of 21% through 2013, according to Frost and Sullivan. According to an EIA analysis, the energy efficiency market opportunity could equate to \$520bn of investments that could translate into \$1.2trn of gross energy savings and a 23% reduction in annual energy consumption by 2020. We recommend Ameresco (AMRC, C-1-9, \$14.13) as an attractive pure play on the governmental energy services trend.

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Bank of America Merrill Lynch



John G. Inch Research Analyst MLPF&S john.inch@baml.com	+1 646 855 2454
Elana Hordon Wood Research Analyst MLPF&S elana.wood@baml.com	+1 646 855 2259
Steven Milunovich, CFA Research Analyst MLPF&S steven.milunovich@baml.com	+1 646 855 1272
Peter Christiansen Research Analyst MLPF&S peter.christiansen@baml.com	+1 646 855 5622

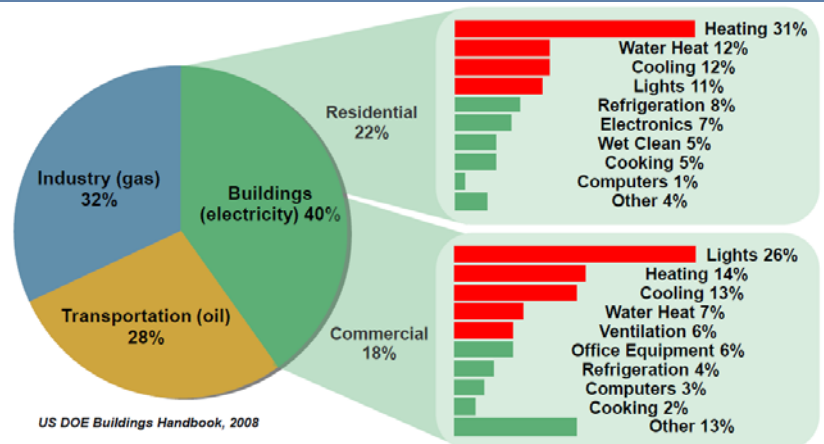
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Energy Efficiency industry overview

The Energy Efficiency industry encompasses both product suppliers (e.g., manufacturers of thermostats) and enterprise building integrators. Overall, volatile and high energy prices, coupled with tightening regulation around emissions, are expanding the market opportunities for a variety of industrial companies, including Honeywell.

In the US, buildings consume 40% of the country's power (split roughly 55% residential/45% commercial). On the residential side, the biggest use of electricity is for heating (>30% of total electricity usage) whereas in commercial markets, the biggest use of electricity is for lighting (>25% of total consumption). Honeywell estimates that building automation tools can control/lower nearly two-thirds of the energy use in homes and buildings.

Exhibit 1: US Energy consumption



Source: US DOE, Company presentations, BofA Merrill Lynch Global Research.

Table 1: Honeywell Automation and Control Solutions (ACS) profile (\$bn)

	2011E
Honeywell (total company)	36.9
Automation and Control Solutions (ACS)	15.7
Honeywell Products	9.7
Env. & Combustion Controls (ECC)	3.5
Life Safety	2.8
Scanning & Mobility	0.5
Security	2.4
Sensing & Controls	0.6
Honeywell Process Solutions	3.1
Honeywell Building Solutions	2.9
Energy Solutions	1.0
Energy Performance Contracting	0.6
Energy Services	0.2
Utility/Smart Grid	0.2

Total Utility/Smart Grid across ACS 0.5

Source: Company reports, BofA Merrill Lynch Global Research.

Roughly 60% of Honeywell's nearly \$16bn Automation & Control Solutions (ACS) segment is linked to Energy Efficiency. Honeywell ACS products and services enable building owners and end users to optimize efficiency. Depending on the situation, factors may include cost, comfort, energy output and energy consumption.

Profile of Honeywell Energy Solutions

Jeremy Eaton manages Honeywell's \$1bn Energy Solutions business that is housed within Honeywell Building Solutions – see Table 1.

The ~\$1bn of Energy Solutions sales is comprised of roughly \$600mm of Energy Performance Contracting, ~\$200mm from Energy Services (non-guaranteed energy projects, energy-related services), and ~\$200mm from Utility/Smart grid (the combination of Honeywell Utility Solutions, Akuacom, and International Smart Grid).

Note that a portion of Honeywell's Smart Grid business also resides in Honeywell Environmental & Combustion Controls (ECC) business – Honeywell's overall Smart Grid exposure is closer to \$500mm (broadly defined).

The Energy Solutions business works directly with commercial building owners and utilities (vs. through product distribution channels). Not surprisingly, the Energy Solutions team works closely with Honeywell's product groups on new product roadmaps. In addition, there is dialogue between Energy Solutions and Honeywell Process Solutions, since industrial customers also have energy efficiency demands.

Honeywell Energy Solutions competition is comprised of two groups – large conglomerates such as Siemens and Johnson Controls – and smaller energy performance contracting pure-plays or ESCOs such as Ameresco and Noresco. Within utility/smart grid markets, Enernoc and Converge are peers. In the context of energy retrofits/services, the landscape is comprised of mechanical contractors that focus on the installation of new products vs. providing a holistic solution.

There is reportedly scalability within the Honeywell Energy Solutions business with regard to smart grid - remote monitoring and commissioning. Many of the Smart Grid or Demand Response programs begin with a small pilot and then expand to a large rollout with relatively low incremental associated costs (ie, design engineering).

Global opportunities

Energy Efficiency mandates are global and Honeywell's opportunity outside the US is tremendous. Europe, for example, is considerably further ahead of the U.S with regard to energy efficiency despite its older building infrastructure.

Honeywell's Government Relations VP in EMEA, Richard Graber, is actively involved with international governments to help establish viable public policies such as the “**Green Deal**” in the UK.

In Dec 2010, the UK's Energy Bill included a provision for the Green Deal. The Green Deal offers consumers energy efficient improvements at no upfront cost; the expenses would be recouped by the government over time as the energy savings accrue. Expected savings must meet or exceed the cost of the implementation of the savings measures. The program covers both residential and commercial buildings.

Australia is aggressively pushing energy efficiency through **NABERS** program. NABERS is a performance-based rating system for existing buildings. A building is rated on the basis of its measured operational impacts on the environment – a 5-star is the highest rating. Beginning later this year, it will be mandatory to disclose a NABERS rating when office space exceeding 2,000+ sq. meters is offered for lease or sale. Highly rated NABERS-rated buildings reportedly command higher market valuations vs. non-rated buildings, which creates financial incentives for building owners to upgrade.

Honeywell Energy Solutions has been playing a key role in the NABERS implementation. Honeywell establishes contracts whereby they guarantee specific star-ratings vs. cost savings (per a typical performance contract). Honeywell provided an example of a commercial facility upgrade where the company employed energy efficient control strategies (eg, grid-synchronized co-generation system for low carbon electricity, space heating and water heating; new high efficiency chillers and water efficient cooling towers) to elevate a commercial building from 2.5 stars to 4.5 stars. In the 9-month, process, Honeywell reduced the base building energy consumption by 40% without any disruption to the tenants.

NREL on Efficient Commercial Buildings

Specialization measures determine ROIC

For most developers, integrating the highest value energy efficient solutions depends on knowledge of a particular vertical in relation to the vintage of the building architecture. Antiquated structures should be ripe for efficiency savings, though often require extensive overhauls for some applications, thus inhibiting return on capital. The same holds true across different verticals, where different applications provide varying levels of savings and return in different segments. In tandem, energy efficiency specialists must balance these factors in efforts to maximize facility savings and return on capital.

In light of these factors, we believe it is likely that a number of newer entrants could enter the space with the aim of carving out a particular end-market, particularly in the commercial markets. ESCOs today are primarily focused on the MUSH (Municipalities, Universities, Schools and Hospitals) markets due in part to the availability of financing mechanisms. Overtime, as the benefits of efficiency measures become more apparent, we would expect a greater degree of commercial growth which would command a high degree of specialized service and design.

Changing the design process mindset

NREL's Bill Livingood pointed out that because energy efficiency is often not a primary consideration during the building process, the opportunity to incorporate energy efficient measures are limited to equipment. By incorporating a more holistic energy-based design, structures can benefit beyond the scope of equipment solutions, taking into account building form and fabric. The process of utilizing energy simulations aims to create the highest impact by tackling energy decisions in the earliest phases of structure design. Programs such as LEED certification encourage this process and as is often the case, efficiency mandates are less costly to implement when incorporated earlier.

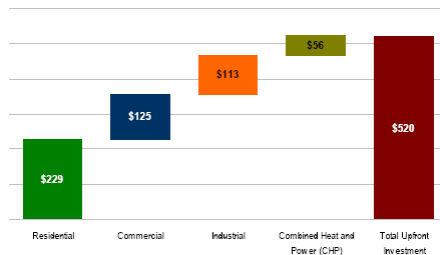
Targeting efficiency

On the call, NREL highlighted its own 220,000 square foot headquarters in Colorado. The building is classified as LEED platinum and offers a 50% reduction in energy costs as compared to non-LEED architecture. Not including its photovoltaic system, this highly replicable structure incurred construction costs of \$259 per square foot. In addition to using efficient materials and equipment, the form of the structure works to incorporate as much daylight as possible with having employee workstations no more than 30 feet away from a window. There were also a number of "plug load reduction" strategies utilized, including efficient traction elevators, reduction of copiers/printers, more laptops than desktops, LED lighting and centralizing break-rooms and pantries. One of the more impactful measures pertains to the building's data center, where blade servers with virtualization coupled with high efficiency UPS (Uninterruptible Power Supply) dropped load by 20-30%.

Real-time diagnostics enhance savings 5% to 20%

Identifying these one-time measures and applications for new buildings and retrofits can be discovered via energy audits known energy commissioning. Enterprise energy management systems or monitoring based commission tools aim to provide a similar benefit, though on a continuous or even real-time basis. By installing controls, sensors and diagnostic systems throughout a facility, a facility manager/operations center can identify anomalies and inefficient patterns of energy use. This allows managers to be more proactive, solve issues remotely

Exhibit 2: Energy efficiency market opportunity



Source: EIA AEO 2008, McKinsey analysis, BofA Merrill Lynch Global Research.

and improve quality controls in a real-time fashion. In addition, energy analytics can recognize inefficient patterns and provide recommendations to improve efficiency. NREL sees continuous energy efficient controls potentially providing 5% to 20% in annual energy savings.

ESCO overview

An **Energy Service Company (ESCO)** is a commercial business providing a broad range of comprehensive energy solutions including design and implementation of energy savings projects, energy conservation, energy infrastructure outsourcing, power generation and energy supply, and risk management.

Energy management services are accessible and scalable options to improve efficiency and lower energy costs. Driven by aging and inefficient infrastructure and coupled with federal and state regulatory policies, the market for energy management services was estimated to be more than \$20bn in 2009 and is expected to grow at a compounded rate of 21% through 2013, according to Frost and Sullivan.

According to EIA analysis in 2008, the energy efficiency market opportunity could equate to \$520bn of investments that could translate into \$1.2trn in gross energy savings and a 23% reduction in annual energy consumption by 2020. Currently, most ESCOs are focusing on government energy efficiency offerings and small-scale renewable energy plants.

Interest in energy efficiency services is driven by a renewed focus on demand-side energy management, fiscal stimulus, and legislative support in the form of energy efficiency resource standards (EERS) designed to address increasing electricity demand and climate concerns.

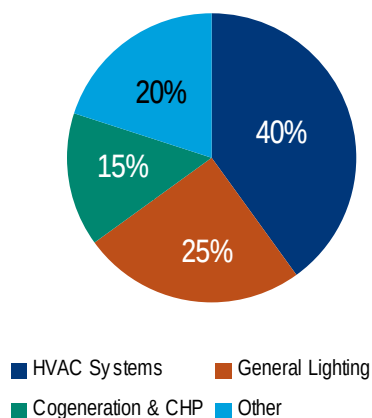
Exhibit 3: Government support for energy efficiency

American Recovery and Reinvestment Act, 2009	Department of Energy (DOE)	American Clean Energy and Security (ACES) Act, 2009
• \$38.7 billion in funding allocated for energy efficient solutions • Representative awards: • \$3.2 billion - energy efficiency ft conservation block grant program • \$3.6 billion - DOD energy efficiency projects and modernization of facilities • \$8 billion - weatherization programs • \$4.5 billion - General Services Administration to convert to "green buildings"	• Awarded 16 contracts to energy service companies ("ESCOs") for up to \$80 billion (Dec. 18, 2008) • Energy efficiency, renewable energy and water conservation projects at federal facilities	• House passed; currently in Senate • Combined Efficiency and Renewable Electricity Standard (CERES): • Requires all electric distribution utilities to provide 20% of electricity from EE and RE by 2020 • Energy Efficiency may account for 25-40% of utility target • Carbon Cap and Trade: • Monetizes emissions reductions from the projects of our core businesses • Low Cost Financing • Provides for DOE support of Property Assessed Clean Energy (PACE) bonds

Source: NREL, BofA Merrill Lynch Global Research.

At the federal level, government buildings are mandated to reduce energy use by 30% by 2015. We would not bet on that figure being achieved, but it does put energy efficiency front and center, which we have seen benefit vendors such as Cree in LEDs. In addition, the nearly \$26bn in efficiency and renewable stimulus funds already doled out by the US government has treated ESCOs well, with the industry receiving \$38.7bn in rebates courtesy of Section 1603 of the American Recovery and Reinvestment Act of 2009 (ARRA). ESCOs typically used the funds to reduce the cost basis of a renewable energy project that otherwise qualified for production tax credits under the Internal Revenue code.

Chart 1: Industrial energy demand by category



Source: Frost & Sullivan, 2008, BofA Merrill Lynch Global research

Energy efficiency performance contracting

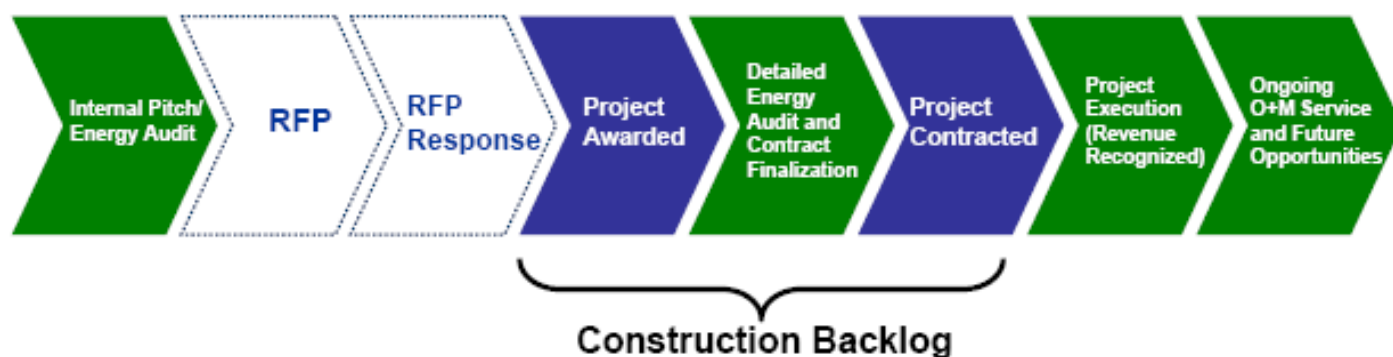
Energy saving performance contracts (ESPCs) encompass the development, design, engineering, and installation of equipment that reduce the energy costs of a customer's facility. Generally this involves improvements to a building's heating, ventilation, cooling, and lighting systems. An ESCO also may design and build a central energy plant or cogeneration system to provide power, heat, or both to a customer's building. Other traditional product offerings include the replacement of smaller energy-using equipment; roof, window, or insulation upgrades; and assistance in executing demand response and demand-side management programs.

ESPCs typically have terms of 7-20 years. One way both ESCOs and their customers are attempting to overcome trying times in the credit markets is by increasing contract periods. Clients find great value in ESPCs because the energy savings realized services debt related to project financing. By extending contract periods beyond 20 years, more capital improvements resulting in greater energy savings and smaller incremental debt payments become possible.

A typical ESPC defines what equipment will be installed and quantifies the energy savings a customer can expect. ESCOs are then paid on a percentage-of-completion basis from an escrow account. When the customer accepts the project, the customer begins to repay the financial institution out of the energy savings. Contract margins typically run 15-20% above equipment acquisition cost. Construction spans 6-30 months and some ESCOs are expected to provide O&M services for the duration of the contract period.

The energy savings guarantees are classified as either pre-agreed, equipment-level, or whole building-level. Pre-agreed contracts state that the reduction commitment will be met shortly after installation of the equipment. Equipment-level guarantees are commitments to a reduction level determined by the difference in use between the existing and replacement equipment. Whole building commitments require demonstration based on utility meter readings that energy usage will be reduced for the whole building upon project implementation.

Chart 2: Ameresco's contract execution process



Source: BofA Merrill Lynch Global Research, company reports

RFP activity is increasing

A little budget pressure actually is good for the ESCO industry because local governments are appreciating that ESPC contracts are paid out of energy savings and require no upfront outlay. Financing is now becoming widely available in the MUSH (Municipalities, Universities, Schools and Hospitals) markets. Stimulus money slowed decision making, which now is picking up. Rising interest rates are a slight negative, but offset by 40% of efficiency savings being tied to oil, which has seen a steep price increase recently.

Price objective basis & risk

Ameresco Inc. (AMRC)

Our price objective of \$17.50 is supported by three valuation metrics: (1) one-year forward EV/EBITDA target multiple of 14x our 2011 EBITDA estimate of \$71 million, representing a 20% premium to a select group of smart grid and efficiency related comparables, (2) one-year forward P/E target multiple of 20x on our 2011 adjusted EPS estimate of \$0.88, corresponding to a blended average of efficiency and renewable project developers, and (3) a discounted cash flow analysis supporting a \$18-19 valuation with a WACC of 13.2% and a terminal EV/EBITDA multiple of 6x. We expect that investors will begin to focus more on the energy efficiency aspect of the story and less on the construction side over time.

Risks to our price objective: (1) softness in the credit markets, resulting in difficulty in getting projects financed, (2) increased competitive focus in the energy services business from large equipment manufacturers, (3) a reversal in supportive governmental policy and stimulus for increasing energy efficiency measures, and (4) lack of backlog growth that is the well for future revenue growth.

Link to Definitions

Industrials

Click [here](#) for definitions of commonly used terms.

Technology

Click [here](#) for definitions of commonly used terms.

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US - Alternative Energy Coverage Cluster

Investment rating	Company	BofA Merrill Lynch ticker	Bloomberg symbol	Analyst
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	Ameresco Inc.	AMRC	AMRC US	Steven Milunovich, CFA
	Covanta Holding Corporation	CVA	CVA US	Steven Milunovich, CFA
	Ener1 Inc.	HEV	HEV US	Steven Milunovich, CFA
	First Solar, Inc.	FSLR	FSLR US	Steven Milunovich, CFA
	Itron Inc.	ITRI	ITRI US	Steven Milunovich, CFA
UNDERPERFORM				
	Clean Energy Fuels Corp.	CLNE	CLNE US	Steven Milunovich, CFA
	Cree, Inc.	CREE	CREE US	Steven Milunovich, CFA
	EnerNOC Inc.	ENOC	ENOC US	Steven Milunovich, CFA
	Fuel Systems Solutions	FSYS	FSYS US	Steven Milunovich, CFA
	Ormat Technologies, Inc.	ORA	ORA US	Steven Milunovich, CFA
	SemiLEDs Corp.	LEDS	LEDS US	Steven Milunovich, CFA

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Important Disclosures

AMRC Price Chart



B : Buy, N : Neutral, S : Sell, U : Underperform, PO : Price objective, NA : No longer valid, NR: No Rating

Prior to May 31, 2008, the investment opinion system included Buy, Neutral and Sell. As of May 31, 2008, the investment opinion system includes Buy, Neutral and Underperform. Dark Grey shading indicates that a security is restricted with the opinion suspended. Light grey shading indicates that a security is under review with the opinion withdrawn. The current investment opinion key is contained at the end of the report. Chart is current as of April 30, 2011 or such later date as indicated.

Investment Rating Distribution: Alternative Energy Group (as of 01 Apr 2011)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	5	38.46%	Buy	2	40.00%
Neutral	5	38.46%	Neutral	3	60.00%
Sell	3	23.08%	Sell	1	33.33%

Investment Rating Distribution: Electrical Equipment Group (as of 01 Apr 2011)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	20	51.28%	Buy	7	36.84%
Neutral	12	30.77%	Neutral	6	60.00%
Sell	7	17.95%	Sell	3	42.86%

Investment Rating Distribution: Global Group (as of 01 Apr 2011)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	2009	53.66%	Buy	912	49.89%
Neutral	955	25.51%	Neutral	439	50.93%
Sell	780	20.83%	Sell	257	35.11%

* Companies in respect of which BofA Merrill Lynch or one of its affiliates has received compensation for investment banking services within the past 12 months. For purposes of this distribution, a stock rated Underperform is included as a Sell.

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