New Fundamentals – energy funds in 2020 and beyond

Arran Brown

05/10/2020

"Thank god for coronavirus," they'll say. Though not as eloquent as National Geographic and David Attenborough, nor as determined and wilful as Greta Thunberg and Extinction Rebellion, coronavirus may yet earn the distinction of being a more effective catalyst for righting our climate wrongs. It would be the most exquisite irony if the dreaded death of 2020 was the lifeline humanity needed.

- A version of this story first appeared in the IJGlobal Magazine Autumn 2020

Battered oil prices, petrified transport networks, en masse working from home – these are a few of the unintended effects wrought by the disease that brought with them remissions in carbon emissions. Its lasting legacy, however, will arguably be a renewed vigour to the environmental, social, and governance investment imperative.

The pandemic has served as a test of resilience to systemic shock. It has given investors a painful lesson in risk and volatility, one that will only be repeated with the infinitely more menacing threat of climate change. Indeed, Covid-19 and climate change have a common cause: an unthinking and arrogant appropriation of the planet's resources.

Therefore investors, as well as governments and political entities, are now beginning to look again at how their action can have a material influence in the world. ESG funds and renewable investments have enjoyed stability, outperformance of benchmarks, and boosts in investment in spite of the pandemic.

Renewable generation, storage, and energy efficiency funds will welcome and enjoy their new-found vogue. Better late than never, though there has been an unfortunate lag. Among the managers surveyed for this piece, some have been investing in renewables as far back as 1999.

For the old hands, this is just the latest of several developments in the green fund landscape to occur of late. In the past year several listed funds have altered their mandates, and private players have developed revamped fund offerings reflective of the transformed investing environment.

The Listed Space

Since September 2019, at least three London Stock Exchange Listed funds have requested shareholder consent to altered investment mandates.

On 27 September 2019, energy production-focused The Renewables Infrastructure Group (TRIG) advised shareholders to back plans to recalibrate its geographical mandate from 50% UK, 50% continental Europe exposure to 35:65 in favour of Europe. Shareholders voted overwhelming in favour of the amendment the following month.

At the other end of the energy spectrum, in February this year (2020), the SDCL Energy Efficiency Income Trust (SEEIT) –

asked its shareholders to remove the 25% minimum exposure to UK assets within two years of its initial public offering. It passed the next month.

The latest listed vehicle to change its mandate proposed a geographical *and* technological mandate. In June, Bluefield Solar Income Fund sought approval to change its investment objective and policy to allow for no more than 25% of GAV to be invested in other renewable energy assets and energy storage. Additionally, it said that up to 10% of GAV would be invested outside the UK.

Chris Holmes (*pictured above*), co-lead investment adviser to JLEN, peer to these funds in the LSE-listed segment, offers his views as to why these changes are occurring at this juncture. "Some of it is down to the vintage of the funds – they launched at a time when it was sensible to have an investment mandate as defined at that time with a return expectation which they set out. Then, that was considered achievable.

"What we've seen in recent years is more competition coming into the market for core renewables – onshore wind and solar in particular. It's made it increasingly challenging for some funds, particularly single sector funds to meet their return targets. The natural thing to do is to ask where else can we go?"

Some arguments issue from the fact that these vehicles are finding it ever more challenging to acquire in the space that they set out originally. This is particularly true of those formerly investing in streams of feed in tariffs (FiTs), renewable obligation certificates (ROCs) and contracts for difference (CfDs) – since retired or limited by the UK Government.

Subsidised assets with limited or no exposure to power prices are in demand, meaning in turn that returns on assets with a strong subsidy component are being competed lower.

Outlining its response to these circumstances TRIG noted that European renewables markets still have support schemes (in Ireland, France, Germany). "Elsewhere, falling capital costs, favourable weather conditions, and availability of land have resulted in projects being developed at attractive risk-adjusted returns without recourse to subsidies," it said in a statement at the time, adding that European non-subsidised projects can achieve returns in line with UK ROC projects.

What's more is that the UK is set to add a further 20GW of renewable energy by 2030, compared with Europe's 100GW.

For SDCL founder and chief executive Jonathan Maxwell, there has never been any question that their vision embraced anything but an international profile. SDCL's mandate adjustment is a question of securing the best risk-adjusted reward for their investors while charting a strategic pathway to grow at scale.

"We are going to be doing more in the UK in certain very interesting areas, but what we've found also – as we knew we would – is that there's quite a significant scale of opportunities in continental Europe."

He stresses the importance of tracing fundamental value: SDCL is presently finding more opportunities in North America than in Continental Europe, and seeing more opportunities in the UK than last year. "We just wanted to remove restrictions that would prevent us from deploying capital in the best interest of shareholders."

One of the advantages of SDCL's model is that revenues are not predicated on incentives and subsidies; it's about doing commercial deals not as susceptible to regulatory headwinds.

"We're about energy solutions to corporate, commercial, industrial, and public sector counterparties," he explains, "to help them meet their energy needs on site and reducing their energy demands in the first place. The propositions have to stand on their own two feet. We offer cheaper, cleaner, more reliable, and more commercially-sustainable solutions."

What of JLEN's mandate? The other Chris at JLEN – Chris Tanner (*pictured below*) – and partner at Foresight Group – investment adviser to the fund, illustrates their vehicle's in-built advantage: "We have always had a broad mandate to invest in environmental infrastructure, and that includes things beyond renewable energy, things that go with the themes of sustainability and climate change. We feel that we have the right mandate for the times, in terms of energy sustainability, but more generally sustainability – and climate change definitely. JLEN's mandate can support new ways of contributing positively to climate change and sustainability as new technologies and subsectors develop or become attractive."

Environmental infrastructure is defined by the company as infrastructure projects that utilise natural or waste resources or support more environmentally-friendly approaches to economic activity. Beyond generation of renewable energy, it includes the supply and treatment of water, the treatment and processing of waste, and projects that promote efficiency.

Those haven't always been easy adds, according to colleague Chris Holmes. "Yes, there have been times requiring an education for our shareholders to explain JLEN's decision to add different technologies to its portfolio – anaerobic digestion is an example – but over the years we've proven that investing into this technology was a wise decision and the diversification story is illustrative of the benefits of JLEN's broad mandate." JLEN's mandate has meant it can invest in a wider range of technologies without having to go through the process of shareholder approval.

Progress in Private Funds

Private green energy fund managers have been refining their investment theses and methodologies for as long, if not longer, than those in the public markets. New iterations of funds have on occasion not just been larger as far as LP commitments go, but broader in geographical mandate and technological focus.

Irish fund manager NTR has itself metamorphosed, having been founded in 1975 as a 'classical' infrastructure business, before investing in wind and waste in the 90s, and expanding into wastewater treatment, bio-energy, and solar in the noughties.

The company demerged in 2015 to form Atlas Investments (roads and water) and NTR which exclusively pursued the renewables using vehicles investors were not yet accustomed to.

"When we launched our first fund, we were a bit of an anathema – no one had heard of a long-term fund!" relates Rosheen McGuckian (*pictured below)*, chief executive at NTR.

NTR's first vehicle – NTR Wind 1 LP Fund – which launched in 2015, is a 25-year fund, providing long-term cash yield from the assets for their entire lives.

"We were slightly ahead of ourselves with our first fund. At the time, two out of three institutions I would speak to about long-term vehicles would express uncertainty or say they were interested but internal rules precluded them from participating."

Fortunately, McGuckian sees the acceptance of longer vehicles broadening in appeal, saying the market is coming round to the logic of having a vehicle commensurate with the life of an asset: "The premise was why would you take the time to get an asset built, have it operating beautifully, and then sell it on?"

NTR's first fund was exclusively onshore wind in the UK and Ireland, aiming to target a technology and geography it was eminently comfortable in, and recognising the ROC and REFiT growth opportunity in the UK and Ireland. "But we always knew we were going to go broader and multi-technology thereafter," says McGuckian.

NTR identified solar as another technology with the lowest cost of electricity, adding it to the second fund's – NTR Renewable Energy Income Fund II – mandate in addition to adding a host of new European markets including Benelux, France, Italy, and the Nordics. "We knew that growth would be as big in solar as in wind in Europe and that adding solar smooths seasonality of earnings. We also allowed up to 15% storage to collocate with wind and solar projects. We knew in developing that aspect of the strategy it would be a big part of the future."

Zug-headquartered SUSI Partners has spent the past 10 years developing single-strategy funds across the green energy spectrum. It launched its maiden fund in 2010 acquiring brownfield renewable energy assets, before developing an energy efficiency strategy – Fund I reached final close in 2013, Fund II in 2019 – in addition to an energy storage fund (final close in 2016).

SUSI's history is closely aligned with the maturity of individual technologies which become trigger points for a fund strategy once the technology became reliable enough at scale to provide the basis for returns.

Their latest venture – the largest yet – is the [SUSI Global Energy Transition Fund](), which reached a first close this summer. This flagship product brings together production, storage, and energy efficiency within one vehicle.

Marius Dorfmeister, co-chief executive and global head of clients, rationalises the development: "We see a convergence in the market of the three technologies. Years ago, owing to the availability of technology, it was simpler to come up with products relating to energy production. Nowadays you don't do just energy production; it comes with something else whether that be energy storage, energy enabling, or energy efficiency. It makes sense to reflect the convergence of these technologies by having a single fund."

Marco van Daele, co-chief executive and chief investment officer at SUSI, elaborates: "Technology convergence is one aspect. The commercial dimension is another one. We see business models evolving, combining the technologies from an engineering point of view but it's also possible to find a lot of new commercial ways of monetising those assets beyond just being paid for MW hour produced.

"An example is an investment we've made in Australia. We're backing a developer to roll out a portfolio of residential and commercial behind-the-meter solar rooftop generation and battery storage systems. Combining them leads to a reduction in the energy bill of about 20%, as well as energy consumed. The end consumer doesn't pay for energy consumed, they pay a flat rate that is 20% cheaper than what they used to pay."

Another novelty with the latest fund is its evergreen structure, which they claim is better suited for this holistic approach. SUSI had not used this fund structure previously, explaining that this limitation has been due to traditional fund structures used in infrastructure investing, themselves artefacts of the buyout and real estate world.

Dorfmeister points to several advantages of the evergreen structure, including its efficiency. "An advantage is that it cuts out the need for repeat cycles of due diligence, not only a new manager, but a new legal entity – it saves time. It makes sense for consultants to work with fund managers who are entertaining evergreen structures." He adds that the model can reach investors in countries SUSI hasn't had as many clients from, and appeals, too, because it doesn't limit and cause investors to be stuck for reasons of liquidity.

"In the end, evergreen structures are about doing the right thing for the investor" says van Daele. "This structure avoids potential conflicts between investors and the manager, but also between investors in terms of exits especially. In a closed-end fund the investors need to be monetised at some point. Sometimes that happens at the right point in the cycle, sometimes not. That creates the potential for conflict. Those are clearly avoided with this structure". He also cites growing numbers of LPs who prefer to receive the return but not the capital in difficult and overly-monetised markets.

The next 10 years

Renewable energy generation has been the favourite strategy of many energy and infrastructure funds for the past 10 years. What forces and trends do the coming 10 portend?

Single technology funds are increasingly unlikely to stand out in a growing segment. Some see a bifurcation of the market, where there is a justification for specialist players with deep knowledge of a sector. For van Daele, unfocused yet sub-scale funds might be less favoured. "You'll be competing both with local players who have better networks and with global capital that flows into an increasingly commoditised sector."

JLEN's Chris Tanner emphasizes the importance of the pipeline for these prospective single tech funds. He recommends: "A very strong pipeline in the sector you've chosen. With the history of listed renewables funds in the market, there is a wealth of educated investors who would be happy with multi-technology funds. You've got to have a compelling pipeline that will allow you to be able to hit growth targets in several years' time."

"There is still scope for single technology funds, they do exist and it's a justifiable strategy", argues NTR's McGuckian. "The limitation is what happens when the tap is switched off and the government decides they no longer want to subsidise a particular technology as happened in the UK with onshore wind? The advantage of having several countries in your mandate is that you can go where the growth is and also differing technologies succeed to different levels in different locations – so with multi-jurisdiction de facto you're going multi-technology."

New investment jurisdiction is an avenue being pursued by players in the forthcoming decade. SUSI, notably, is developing local expertise for the launch of its inaugural Southeast Asia fund, which promises a higher risk-return profile. Likewise, Germany's Aquila Capital is understood to be developing its ties in the market there, influenced by Daiwa Energy and Infrastructure's acquisition of a stake in the manager in 2019.

All managers are optimistic for the scope innovation across the next 10 years. Part of that is the convergence of technology which will be reflected in investments and sources of income for funds. "I do agree there is a greying between different areas," says McGuckian. "We already provide paid-for grid firming services with our wind and solar assets. For certain projects, it makes a lot of sense to add storage to projects. You have an expensive grid connection that can take more than your generation can provide for maybe 60% to 70% of the time, so you can collocate two technologies and enhance revenues by selling at time of generation, selling at another time when required, or by providing gird firming services."

Electrification of transport, heating, industrials, efficiency and hydrogen are all sectors earmarked for advancement and targets for funds in the next decade. Subsidies will undeniably form a big part of that. A desire for a green recovery has also unlocked development capital for some of these.

The EU set out green hydrogen as a major part of where investment needs to go. Though some say it's not going to be hugely commercialised in the next 2 to 3 years. Germany and France have announced dedicated capital to catalyse innovation in these areas, in particular hydrogen. As for the UK, JLEN's Chris Holmes believes more needs to be done. "The government should be turning its attention to its long-term net zero target by 2050 and ask itself what the new areas are that need stimulus, be it transport, hydrogen, carbon capture and storage. These are the sectors that need support."

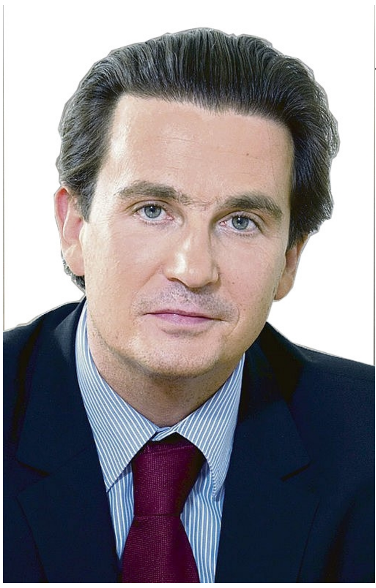
European policy makers have set much more significant CO2 reduction targets for 2030 compared to 2020 goals. A key component in meeting those targets will be by addressing buildings, which constitute 40% of energy demand and 30% of greenhouse gas emissions. A significant way to bring these down is energy efficiency.

SDCL's Jonathan Maxwell is enthused by what this promises. "The solutions for the next 10 years don't look like the solutions of the past 10 years. The renovation wave forming part of the EU's green deal is essentially a euphemism for energy efficiency. The sums being poured into this are absolutely mind blowing. This is really a shift in gears. That's not to say there won't be stimulus in renewables, but what is going on in energy efficiency will be orders of magnitude larger."

Promising applications in energy efficiency include integrating energy efficiency in new build construction, applications for green gas such as greening the gas grid, in parallel to greening the electricity grid.

Continued evolution and innovation will definitely come on the technology side. One of the dimensions often overlooked is on the commercial side. The affordability of technology drives business models and that's the main innovation arena over the next 5 or 10 years according to SUSI's Marco van Daele. "Given technologies are available and reliable at scale and cheaper, the toolkit is there to come up with very innovative business models, and that's the exciting question."

The ESG wave won't be stopping any time soon. Marius Dorfmeister (*pictured below)* highlights the tidal shifts in asset allocation by institutional investors, particularly away from volatility and especially towards ESG propositions.



Undoubtedly the green energy investment fund space is undergoing a renewal of its vows to address global concerns while courting many new suitors. It couldn't be happening sooner. SUSI's van Daele strikes a positive note, though: "If you take the mindset that every challenge is also an opportunity, then climate change being the biggest challenge confronting mankind this century, then it is also the biggest opportunity."