SPECIAL REPORT

EQUITY RECYCLING

How investors can recycle capital and find attractive assets in a competitive market

October 2021

A WORD ABOUT WIND

POWERED BY

TAMARINDO GROUP

IN PARTNERSHIP WITH

RealPort

Contents

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Acknowledgements

RealPort and Tamarindo Group would like to thank the following industry leaders for participating in the Wind Investment Boardroom discussion, which took place on 16th September 2021, and for their permission to be quoted in this report.

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Executive summary

There is no shortage of investor interest in wind and solar assets. In many ways this is good for the renewables industry. It means that lack of capital is rarely an issue.

However, fierce competition for renewable energy assets brings challenges for wind and solar operators too. Companies may find it simple to sell assets, or equity stakes in them, so they can raise capital. But they may then struggle to re-deploy the capital they have raised in new assets with potential returns that match their risk appetite.

In this report we look at this issue, based on a Wind Investment Boardroom session that we ran with headline sponsor RealPort on 16th September. We were joined by a panel of wind farm owners, developers, and other stakeholders to discuss the issues with equity recycling. This is vital to the growth plans of wind owners and operators.

Introduction

The renewable energy industry enjoyed a truly remarkable 2020.

Despite Covid-19, total investment in new renewable energy capacity rose 2% year-on-year to hit $303.5bn in 2020 according to Bloomberg New Energy Finance. That is the second highest year on record, and supported 132GW of new solar capacity and 73GW of new wind farms. Total investment in the energy transition hit $500bn last year – and there's every chance that it will reach a similar level in 2021.

There is a sense that the Covid-19 pandemic has sparked huge interest in the wind and solar industries. Renewable finance experts have spent the last five years telling us there is a 'wall of capital' entering renewables, with interest from all kinds of large institutional investors. This includes global financial players and pension funds to smaller institutions and the family offices of high-net-worth individuals. This grew even further in 2020 and 2021 as investors saw renewables as a safe haven.

We are still seeing the impact of this today. Demand for renewable energy assets is high, yields are squeezed, and buyers typically respond in one of two ways. Either they take more risk than normal when they buy assets, or they accept lower returns.

That shows us the double-edged sword of equity recycling.

On one side, it is positive that there is no shortage of potential investors when wind or solar owners want to sell assets or stakes in assets. This gives them access to a wide range of sources of capital and means that selling presents few obstacles.

But on the other side, it causes big challenges for those companies when they look to deploy the capital they have raised into new assets. Whereas once they benefited from the strong competition among project sellers, now they need to compete themselves – and this makes it difficult for them to find the assets they need to keep expanding.

Our speakers identified two overarching challenges.

First, buyers of renewables assets need to find ways to negotiate competition in the renewables market and still make a profit; and second, governments must help with unlocking the scale of development and investment needed for the energy transition.

That $500bn a year figure is good but, according to Ernst & Young, there is a $5.2trn gap for renewables by 2030 if the sector is to hit targets in the Paris climate deal. We can only get there if there is the quantity of projects for investors to get involved in – and, at present, there is too much capital chasing too few projects.

Technology and development risks

The current huge demand for renewable energy assets means that finding buyers is not an issue for sellers now: "Over the last couple of years, maybe even three years, there has been quite a lot of liquidity," said Simon Robinson, head of investments at UK firm Red Rock Power: "For us, that liquidity piece is relatively straightforward."

He said that this interest ranged from multinationals to family offices. But the level of demand for assets means that buyers are either having to "accept lower returns for the same level of risk… or higher risk in order to maintain their returns targets".

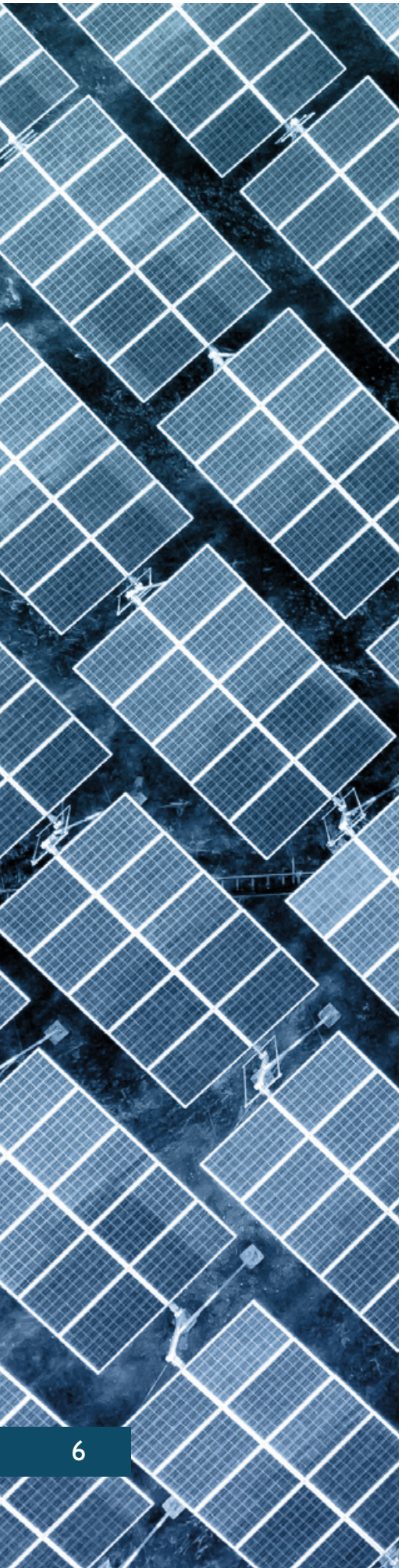
For companies seeking to recycle their equity, these higher risks can mean moving into technologies that are less mature than wind or solar; or getting into projects at an earlier phase of the development cycle. This could mean moving into emerging sectors such as green hydrogen, marine projects, or smaller conventional assets; and also other areas of smart infrastructure, including e-mobility or healthcare.

"There are little corners of the market where perhaps there isn't an enormous depth of capital," said Robinson. That should offer hope in even a competitive market.

Nick Cole, director of financial assurance at DNV, said that investors who have historically been more conservative such as infrastructure funds are increasingly more willing to accept greater levels of development risk, by buying into developers as well as early-stage developments.

He said: "We have a lot of people enquiring about hydrogen and related technologies, but what surprises me is that I will be talking to a traditional infrastructure fund manager and they're saying: 'We're now looking to put money into a hydrogen developer with an aspiration to build projects.' That is not what I would have called traditional infrastructure fund or pension fund appetite. That's almost late-stage VC [venture capital]."

Cole said this shows how traditionally conservative investors "want to be seen to be driving the energy transition" and need to take on different or in some cases, increased risks to achieve that: "A lot of investors are now prepared to take a greater risk or a different approach to risk to what they would have done before," he said. This is a key consideration for firms recycling equity.



Established versus emerging markets

Companies should also not expect to achieve higher returns with vague notions that they should re-deploy their capital in 'emerging markets'.

Luis Arizaga, partner at Exus Management Partners, who is based in Mexico, said it is important for buyers to understand the risks of the individual countries they would be looking to buy in. He said this was important if investors in Latin America are to gain a competitive edge on the utilities and institutions that are already active.

He explained: "They usually come and try to get very big returns and they're not very competitive. But once they understand the risks, and work with people to help detect risks and mitigate them, they come back. All the big guys are here but it took them a while, and usually they start with being more picky [about what they buy]."

Arizaga said that markets such as Brazil, Chile and Mexico are already very mature and have asset owners that are looking to recycle capital to fund their growth, while the likes of Colombia and Peru are still in the early stages. He added that Mexico is also seeing new investment vehicles emerging, including infrastructure REITs.

Meanwhile Doreen Abeysundra, senior investment manager at Siemens Financial Services, joined the discussion from Singapore and shares insights into investment opportunities in the Asia-Pacific region. She said increasing political demand for renewables is offering "incredible" investment opportunity with opportunistic returns, as they are in other parts of the world.

Separately, she highlighted the availability of large amounts of cash within Australasian, Canadian and European sovereign and government-run pension funds, which tend to make equity recycling challenging as investors compete to utilize their liquidity.

There will still be opportunities for renewables investors in parts of these emerging markets, just as there are in regions such as Europe and North America. But firms looking to re-deploy capital should not see any region as a path to quick riches.

Repowering and re-engineering projects

Companies should also look at repowering projects if they want to find opportunities to re-deploy capital – and there are opportunities here for both buyers and sellers.

For sellers, there is an opportunity to raise equity by selling stakes in assets to firms who could then repower them; and, for buyers, there is an opportunity to add value to operational projects that may be coming to the end of their operational lives.

The emergence of this market will also lead to more nuance in how investors assess which operational assets to buy, based on their re-powering potential and the stage of their life cycle that they are at. Operational assets are not created equal.

Andreas Zettergren, partner at Swedish law firm Mannheimer Swartling, said there was an opportunity to recycle equity in repowering projects. But he added that a big challenge that owners faced was securing regulatory support for these projects, as the owners often need to get planning permission and other consents extended.

"That will be an opportunity of recycling equity because obviously we're not now setting up the same machines that were used so long ago, but if you want to use larger machines then you will need to discuss with the regulators and so on," he said. "Across the globe it is one of the challenges to get regulators up to speed awarding permits faster and having a speedier turnaround time."

He said this could mean developers taking back control of their older projects.

"I think maybe the assets will flip back to the developers again. Let's say you have the original developer that did develop the project, and then sold out to an investor. When it comes to the end of its life, maybe they sell it back to someone to do a new scheme," he said. This could lead to new partnerships between buyers and sellers.

Siobhan McAdam, investment strategy manager in generation at Irish utility ESB, said that selling stakes in operating projects could also let owners release capital for redeployment in earlier stage investments

"A large part of your equity return is now subject to merchant risk in the post-subsidy period, which makes players consider whether there is an appropriate time to divest equity and crystallise on the development premiums.," she said.

She added that companies needed to look at ways to be more competitive even at earlier stages of the value chain due to the scarcity of opportunities available for the quantity of capital competing : "We're seeing a lot more liquidity within the institutional capital market that will take construction risk."

Political support for new developments

Investors in renewables will look at how they can find the pockets of value that they need to re-deploy their capital.

However, our speakers also discussed how politicians could unlock new renewables projects. The capital is there and so, increasingly, is the realisation that governments must support more projects so they can hit the goals of the 2015 Paris agreement.

It is a shortage of projects, rather than a shortage of capital, that is the problem. For example, Ernst & Young reported in May that renewables face a $5.2trn funding gap globally by 2030 if the world is to develop the projects needed to hit the International Energy Agency's Sustainable Development Scenario. It said $12.9trn is needed but only $7.7trn has been committed so far. Governments can help bridge this gap with support for wind and solar projects at both national and local government levels.

Mathias Bimberg, head of infrastructure at Prime Capital, put it starkly: "We also see that capital is not the problem, but the pipeline is drying out. The development cycles are too long, and what we need to see is that they are being sped up by politicians."

He said Prime's strategy is to invest in greenfield renewables projects and re-cycle the money opportunistically after five to 10 years. When it looks to re-invest, he said it is increasingly looking at assets linked to green hydrogen, which are popping up in the Scandinavian countries where it invests: "You have to take more risks," he said. "We will increasingly focus on not only to invest in green energy, but do something and try to do something intelligent with it to try to extend the value chain."

Speeding up development cycles would also help companies throughout the value chain, including turbine makers and contractors, who are seeing profits squeezed.

David Rooney, vice president of sales in the UK for Siemens Gamesa, added that fierce competition and high asset prices were forcing owners and operators to put more pressure on their suppliers. He said this is unsustainable in the long term.

"For the industry to work, everyone needs to make a return, including the OEMs [original equipment manufacturers] and the suppliers. Putting pressure into assets and saying, 'We haven't hit our returns and so therefore you have to take risks,' puts contractors and suppliers in a position that may be unsustainable in the long term."

He said it is an industry-wide issue: "If you look at the results of all the OEMs, there are restructurings, margins have dropped, equilibrium between who gets what out of the whole pot has not been struck. It's something to think about and, at some point, the suppliers need to be sustainable as well in the equation."

Practical challenges for deals

Finally, our speakers discussed some of the practical challenges facing companies that want to recycle equity. These all add to the friction around deals.

Robinson argued that one challenge for companies doing deals for smaller assets is that their advisory costs for deals are (broadly speaking) fixed, regardless of how big or small the deal is: "Because the absolute size of the opportunity is smaller, and your costs of advisors and analysing the opportunity are fixed, that means those costs take up a bigger percentage of the deal size. That makes it five times tougher," he said.

One issue with selling stakes in assets that concerned Bimberg was whether the majority owner would retain 'drag-along rights'. These are contractual provisions where a majority shareholder could force a minority shareholder to join in with the sale of an asset. If majority shareholders don't have these rights then they can be restricted in terms of what they can do with an asset when they want to sell it on.

"It would be important for us to have a drag-along right because, when we want to exit, I think this would be a requirement," he said.

Overall, though, our speakers agreed that the funding of assets worked efficiently. Rooney said he hadn't seen a project financing delayed in years: "It just works," he said. "Nobody's coming and saying: 'Oh, we can't get enough people interested. We can't do this, which is what used to happen a long time ago.' Now it's like: 'Yeah, it's all closed. It's oversubscribed. Everybody was interested.' It really goes smoothly."

There is no sign that the sector will return to those constraints on capital.

Conclusion

The experts at our Wind Investment Boardroom were unanimous in their belief that there is no shortage of capital in the renewables industry. This is good news for firms looking to sell stakes in wind and solar assets, but it poses big challenges when they want to re-deploy capital in the sector. The upshot is that they need to take new risks in terms of technology, geography, or the stage they invest in the project life cycle.

Therefore, the key concern for companies is how to balance their risk and reward.

"There's a lot of capital out there, but I think knowledge is also important and to be able to invest at the right time, basically," said Zettergren. This can help companies to find angles in assets that others have missed, and given them a competitive edge on the vast number of investors that are looking to plough money into renewables.

Meanwhile, the message for politicians is clear. There is huge demand for renewable energy assets, but you will only be able to deliver a global energy transition – and to meet long-term climate targets – if you fix the balance between supply and demand. Make it easier for developers and the money will be there.

If you'd like to find out more about our Wind Investment Boardroom programme **click here** or get in touch with the team:

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