

# Roundtable

## Renewables

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## Inflection point

Renewables have crossed the Rubicon when it comes to cost of generation and, increasingly, exposure to power prices. **Bruno Alves** and five of the sector's key managers discuss how the asset class's risk profile is changing, why it's still very much dependent on government support and how storage is still more of a promise than an investment reality

It's one of those comparisons headline writers just love: after crunching data from a range of sources, Germany's Kaiserwetter Energy Asset Management put fossil-fuel generated energy in 2017 across the G20 markets at a cost of between \$49 and \$174 per megawatt-hour. And renewables? Between

\$35 and \$54 per MWh during the same period.

Of course, cost of generation isn't the be-all and end-all, certainly not for the five renewable energy investors we have gathered for our annual renewables roundtable – a group that includes Glennmont Partners' Joost Bergsma, who graciously

hosted our discussion; Conquest Asset Management's Stephane Wattez-Richard; KGAL Investment Management's Michael Ebner; Actis's Adrian Mucalov; and Foresight Group's Dan Wells. But as an icebreaker, it's hard to beat, so we couldn't resist asking our participants whether Kaiserwetter's recent findings are proof



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that every new megawatt of generation should, henceforth, be coloured green?

“We cannot say yet that renewable energy is the cheapest of energies. But that is definitely the path it is on,” starts Watz-Richard. “However, as always, it’s about the end and the means to the end. We cannot look at renewable energy in isolation, as a standalone asset on the energy grid. As it becomes more widespread, it has a growing impact on the ageing traditional networks, the costs of which will need to be borne by the renewable operators.”

Ebner agrees that few conventional power sources can compete with renewables on a MWh basis but warns that “security and stability of supply can today only be achieved if conventional power sources support renewable energy. However, this necessary support is expected to fade over the next years”.

While Watz-Richard and Ebner are active in Europe, the story is similar in emerging markets – Actis’s playground.

## AROUND THE TABLE



### **Joost Bergsma, founding partner & CEO, Glennmont Partners**

A power and utilities veteran with over 12 years of experience under his belt, Bergsma is actively involved in originating Glennmont’s deals, having executed on some of the firm’s key wind and solar deals. He has held senior roles at BNP Paribas (formerly ABN AMRO) and SG Warburg & Co.



### **Michael Ebner, spokesman for the management board, KGAL Investment Management**

Ebner joined KGAL in 2015, where he’s also responsible for the firm’s infrastructure division. In that role, he takes responsibility for transactions as well as asset and portfolio management. In addition, he also oversees KGAL’s human resources, structuring, and marketing communications divisions. He was at Dresdner Bank prior to KGAL.



### **Adrian Mucalov, partner, infrastructure, Actis**

Mucalov is responsible for originating and managing infrastructure investments at Actis, which he joined in 2009. He has been heavily involved with several of the firm’s energy investments across Africa and Latin America. Prior to Actis, Mucalov worked as a management consultant with Monitor Group & Monitor Corporate Finance, in Toronto and Seoul.



### **Stephane Watz-Richard, director, Conquest Asset Management**

Watz-Richard is primarily responsible for investment management and driving deal origination, structuring and execution at Conquest AM, and is a member of its investment committee. Before joining Conquest in 2012, he had previously spent about 15 years in senior roles in investment and corporate M&A with the likes of Schneider Electric, Areva Transmission & Distribution and Cable & Wireless.



### **Dan Wells, partner, Foresight Group**

Wells joined Foresight in 2012 and is based in their London office, where he’s responsible for the firm’s existing retail solar funds as well as deploying its energy infrastructure strategy more widely. Before his time at Foresight, Wells, who has 17 years of experience under his belt, was a managing director in Sindicatum’s corporate finance division.



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Bergsma

“Many new wind and solar plants that are being built in our markets are producing energy at a cost of \$30 to \$45 per MWh. What’s more, in places like Brazil, for example, we have wind farms running net capacity factors of over 60 percent. So, you could easily produce two to three times the power you’d get from the same wind farm in Germany,” Mucalov says. “That is helping make renewables even more competitive in our markets. But the countries where we are active are industrialising and they also need 24/7 power. Renewables are intermittent, so in the absence of scalable battery technology, they can still only be an element of the power system today.”

Wells offers a different perspective: “I think, increasingly, the key consideration is when and where an electron is produced and to what extent there is control over it. In that sense, the value is as much

about how you manage electrons as how you generate them. The other thing to consider is that renewables are quicker and easier to build. So, when you take all those factors into account, I’d say we’ve been through an inflection point over the past two to three years where renewables have become the dominant form of new-build generation.”

### GOODBYE SUBSIDIES...

Does that mean, then, that renewables have also reached an inflection point when it comes to government subsidies? Or government support, for that matter? After all, renewables have been trending towards the unsubsidised end of the spectrum in Europe and Donald Trump’s election doesn’t seem to have slowed down the growth of US clean energy generation.

“Clearly, this remains a regulated sector, so it’s certainly helpful to have some government support, not just in terms of the feed-in tariffs, but also in terms of grid connection,” Bergsma says. “But I think there continue to be important drivers in Europe. Energy pollution continues to be a big one; and energy security is very important in driving government support for clean energy, particularly as geopolitical uncertainty has accelerated over the past 24 months and parts of Europe are running out of gas.”

“When people think of government support, they usually think of subsidies,” Mucalov interjects. “Today, with the decrease in the price of renewables in our markets, we don’t require a direct government subsidy. But I would say that in all our markets, government is heavily involved. For example, some are completely liberalised and have merchant markets, but many don’t have merchant wholesale markets, so you’re actually operating through long-term power-purchase agreements. That means you’re either selling to a government entity or if you’re selling to another entity, it’s regulated in some way. So, it’s absolutely crucial to have strong government regulation and clear rules for foreign investors.”

## HELLO PPAs

As the market moves away from direct government subsidies towards merchant exposure, power-purchase agreements have emerged as one of the most important developments in the industry. Widely seen as a bulwark against a significant increase in the sector's risk profile, PPAs matter because one of the reasons renewables have been such a hit with investors is due to their perceived low risk.

"With a PPA, your starting point for your investment is riskier and the price you're getting for the PPA is riskier, too," Bergsma admits. "As we move away from feed-in tariffs, you'll need to factor in at least three components to create a stable, long-term cashflow. One is to have a PPA where you mostly have merchant risk, but you still have a floor price. Secondly, renewables are intermittent, so operators will probably need to start providing some form of grid stabilisation payment. Finally, there needs to be some form of carbon payment, and it's telling the EU is now looking again at how to price carbon."

KGAL's Ebner is not so sure PPA structures are higher risk, warning there was plenty of risk built into tariff-backed assets, too. "Feed-in tariff projects have typically been leveraged quite highly, so the equity investor actually took a merchant-power risk in the past as well. Look at Italy. We're not exaggerating in saying that the feed-in tariff there was largely spent covering the debt service plus the opex and the equity was to a large extent served by pure merchant power revenues. Therefore, I don't really believe there's a huge difference between the highly leveraged feed-in tariff projects of the past and the new ones, with PPAs as base structures."

As Wells points out, though, PPAs are not a one-sided proposition. "One must have which is not an explicit contractual term, but more of a comfort factor, is that the PPA has to also be a good deal for the corporates, otherwise you're going to be in a position in, say, three years' time where you might be dealing with buyers' regret.

So, it's not just about charging for the tightest possible deal, but also about making sure you have a sustainable contract."

And for those with wider remits, like Conquest's Watez-Richard, PPAs can open other doors: "Discussions with industrial partners around PPAs can and should become broader conversations with those partners looking for asset deconsolidation opportunities."

## MAKE THEM SWEAT

One thing that has certainly changed about the market, particularly in Europe, is its return profile, which has compressed significantly over the past few years. This is a well-known phenomenon, but worth exploring around a table where wind and solar – the most mature technologies – emerge as a key part of our participants' portfolio.

"Solar PV, within the sustainable

“Feed-in tariff projects have typically been leveraged quite highly, so the equity investor actually took a merchant-power risk in the past as well” Ebner



infrastructure segments we invest in, remains a priority,” says Wattez-Richard. “One reason is the stability of its proven technology and energy production, which means solar energy has relatively lower maintenance needs as well as better predictability. That translates into a better risk profile than onshore wind, even though their respective prices tend to converge. Also, the market is fairly fragmented in Europe, which allows asset managers like ourselves to bring value via aggregation of smaller assets into larger portfolios, which direct investors are less inclined to do.”

Bergsma, who has been active in Europe for more than a decade, argues the continent still offers a deep set of brownfield opportunities. He is also enthusiastic about offshore wind, particularly how quickly it’s weaned itself off subsidies. And, while he acknowledges there is a lot of capital out there, that money has been chasing large deals, which leaves plenty of opportunities for mid-market managers such as Glennmont.

However, he admits managers must work harder for their returns. “Today, with good asset management capabilities, you can really sweat those assets and squeeze out cost,” he says. For brownfield assets backed by tariffs in a “strong country”, that means “5 to 7 percent levered IRRs for something that is scalable”. More complex assets, such as biomass, will generate higher returns.

Ebner, though, isn’t a fan of industrial-scale biomass, even if it does provide an upside. “The main challenge of biomass is that you’re operating in the energy market but also in the dual-use feedstock market, and they can evolve in totally different directions. My second issue is that, when we looked at biomass in the past, we were often asked by our LPs how sustainable and ethical biomass was and ultimately a lot of investors declined to invest in it.”

For Foresight, which manages both yield- and value-seeking capital, the compressed returns landscape, not

just in Europe but also in the US, has pushed those value-seeking pools of capital towards the development end of the spectrum.

“We look to maximise returns by obviously doing more greenfield and, increasingly, taking a hands-on, late-stage development approach to life,” Wells explains. That’s because “the construction premium has narrowed considerably over the past few years and there is a recognition that solar, particularly in developed markets, is not very difficult to do”.

Mucalov, of course, is in a completely different position, given that the wind, solar and hydro assets Actis invests in “generate a substantially higher return in our growth markets”. The flipside to that is that Actis still has to combat investor perceptions about growth markets’ higher risk profile, even if the data doesn’t necessarily show higher default rates.

“In order to attract foreign private capital,

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Wells





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Wattez-Richard

many of these governments actually offer what we believe are a better set of risk protections. In many of our markets, governments offer US-dollar contracts and full government guarantees, sometimes backed by MIGA or other credit enhancements. In some markets you do have to take some local currency risk – or even full currency risk – but the majority of our markets still offer hard currency returns to investors as well,” he says.

#### THE GREAT LEVELISER

As our conversation comes to an end, storage as an investment opportunity comes up. Everyone around the table is sold on the impact storage will have on the energy market and beyond. As Wattez-Richard puts it: “Storage is already and will remain key to the distributed energy sector in general and to the renewables industry in particular. Its technology also impacts both the grid and electro-mobility. In that sense, we are

looking at storage as part of a wider sustainable infrastructure investment strategy.”

What our participants are less sold on, is storage’s immediate investibility. A quick show of hands reveals everyone is able to invest in storage, but hurdles ranging from “unproven technology” to lack of a “sound business case without subsidies” mean that all but one of our participants is currently investing in it.

The exception is Foresight, which is already “heavily invested” in storage, so it’s only fair that Wells gets the last word: “From a technology standpoint, lithium-ion is a fundamentally proven technology. The technology risk is more about what are the competing assets that can provide the same service – for example, frequency regulation getting done by solar or smart inverters in the future. Battery degradation is also a factor, given it occurs at different rates depending on how you use your asset.”

He continues: “In terms of applications – co-location, standalone or behind the metre – our view is that co-location with renewable assets has a real role to play only when there is a sufficient case for the value of time-shifting that energy. Standalone batteries provide great opportunities if there are sufficient contracts in place. And behind the metre has a big role to play, but in many markets it is still a long way off from being cost-competitive.”

Yes, but is storage an infrastructure play in the end?

“To think of storage as an infrastructure asset, you need to go through several layers. Firstly, you need to identify what the mix of contracted versus uncontracted revenues is going to be. But even with a highly contracted asset, your payback period is going to be six to eight years – so shorter than your average infrastructure asset – which means you need a higher return. But storage has a real role to play as part of a diversified portfolio, so not just alongside generating assets, but transmission and distribution assets, too.”

Watch this space. ■