

Return Characteristics of Renewable Energy Infrastructure Investment

An opinion piece by James Stacey, CPSL Senior Associate; Partner at Earth Capital Partners

The past few years have seen increased questioning of appropriate asset allocations for long term investors, such as pension funds. The CPSL P8 process is one example, highlighting the significance of climate change to long term investment decision making.

The “cult of public equities” became embedded in pension manager and consultant thinking in the 1980’s and 1990’s, and has dominated pension portfolios for the past 3 decades. Real returns of 10%+ were achievable for 20 years until the momentum ran out in December 1999, when the FTSE 100 peaked at 6930. Over 10 years later, it is today at 5051 (as of 09/06/10). Combined with ever lower Government yields and the gales that have blown through credit markets, this has left long-term investors searching for overall yield/return and income, whilst recoiling from risk and seeking ways to match their long term assets with more predictable, but relatively high yielding investments.

A recognition has emerged that real assets (be it “pure” real estate or wider infrastructure investing) have a critical and more significant role to play in pension fund portfolio construction, whilst simultaneously the evolution of SRI (and related themes) into Environment, Social & Governance (ESG) investing has reinforced a longer term perspective. Infrastructure funds are evolving to reflect reduced investor appetite for leverage (debt) and the reduced availability of bank debt. This has led to a re-focusing of attention on their bond-like characteristics, rather than the super-equity-like target returns of highly leveraged infrastructure funds of the recent past.

The traditional approach to investing in these assets, which sought to exit assets once operational for capital gain, is no longer the only option. With double digit steady-state annual income generation, a longer term build/operate approach is also possible, if not preferable in some circumstances. This offers the ability to operate a longer investment term than has been of vogue in recent years without running significant additional risk or costs. Capturing the construction risk premium, but discarding the ‘lottery’ of development risk allows schemes to generate long term dependable returns without adding unwanted risk.

Renewable energy has emerged as a sub-sector within the infrastructure class which fits this long term characteristic. Looking ahead, there is an estimated US\$5 trillion investment opportunity through to 2030 in new renewable energy capacity globally [1]. EU policy has created an estimated investment requirement of €1 trillion to 2020. This growth is underpinned by the wider EU energy concerns of energy demand growth and energy security concerns. Renewable energy investment vehicles can offer such a stable long-term cash flow profile guaranteed by national governments (which is embedded in some national legislation) and with some investments benefiting from an index (inflation) linking.

So what are the desirable characteristics of such an investment vehicle that are also compatible with the requirements of institutional investors, such as pension funds and sovereign wealth? The vehicle needs scale to facilitate an institutional investor’s participation (they are often unable to invest in small funds) and to deliver adequate diversification. It also needs clear definition of the technology types and how much technology risk is acceptable (seeking new technologies was historically used to increase overall returns, but with related increases in investment risk).

Avoiding development risk (finding and securing the site, licences and connection to the grid) reduces the need for an early asset sale to achieve returns commensurate with the risk. Investing at financial close captures construction returns, and holding through much of the lifetime of the asset allows an investor to collect a more controlled and predictable revenue stream.

Finally, whilst the evolution of SRI into Environment, Social & Governance (ESG) investing has reinforced a longer term perspective, for those pension funds which recognise their broader social responsibility, investment in sustainable infrastructure offers clear ESG benefits without compromising their fiduciary duties.

[1] World Economic Forum, Green Investing (2009)

June 2010