

## INVESTMENTS

# How to generate powerful renewables deals



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Renewables are a tough sell for private equity, requiring much longer holding periods than the average fund

**As oil prices plunge to new lows and political pressure continues to mount on corporates to improve their green credentials, the environmental sector is experiencing undeniable momentum. In the first part of this series, José Rojo looks at why private equity has avoided renewables and reveals which areas of the green economy are more suitable for investment**

In December 2015, the visibly delighted French Minister of Foreign Affairs and International Development, Laurent Fabius, broke the news that after two exhausting weeks of negotiations, the long-awaited Paris agreement on climate change had been signed by 196 countries. The deal resulted in a common pledge to keep global warming to 1.5°C above pre-industrial levels through emission-cutting plans in each country.

Although unsatisfactory to some, the deal did away with memories of the Copenhagen summit fiasco of 2009 and was hailed as a turning point by many in the financial world. As economist Jeffrey Sachs cautioned in a *Financial Times* comment piece, the COP21 negotiations were a success for diplomats, but it is now up to all other stakeholders, investors included, to ensure the deal makes a genuine impact on global emissions.

Meanwhile, the World Economic Forum recently released a report in which, for the first time, climate change was placed top among 10-year global risks. The future of fossil fuels and renewables, sustainable development goals and other environmental topics also featured heavily in WEF's annual meeting in Davos at the end of January.

The pressure to go green is not only coming from high-profile commentators and conference attendees, but also from the market itself. Indeed, with oil prices having recently fallen below \$30 per barrel, RBS economists urged clients to "sell everything" before the commodity's downwards spiral wipes off even more value from portfolios. This green economy momentum begs the question: is private equity ready to rethink its long-held mistrust of the sector?

## Revisiting renewables

After sounding out numerous generalist private equity firms, general sentiment towards investing in renewables continues to be negative. By far the most iconic of all environmental segments, clean energies, are simply not a good fit with the private equity model and no worldwide agreement will ever change that, says Nino Tronchetti, founder and managing partner of Italian environmental-focused investor Ambienta. "It doesn't work. The returns are not acceptable for private equity. As a GP, I simply can't invest where subsidising is involved, I can't base my strategy on policy," he says.

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Over-reliance on state support has long been one of the main deterrents for GPs contemplating a move into renewables. While government initiatives in this area can be generous – as shown by the recent pledge by French state investor BPI France to channel €4bn into the green economy by 2018 – it can also be equally merciless, leaving investors stranded when subsidising schemes are dismantled.

Indeed, eight years after the Spanish government set up a funding programme for renewables, the scheme was scrapped in 2012 on the basis it had spawned a €24bn deficit. The news was a severe blow to players including HgCapital, the owner of several photovoltaic projects in the country. The GP downgraded the value of its Spanish renewable assets and was rumoured to be planning legal action against Spanish PM Mariano Rajoy's administration, alongside KKR and a number of infrastructure funds.

In a deficit-obsessed Europe, Spanish policymakers have not been alone in targeting renewable schemes. Italy froze all financial aid to the photovoltaic sector last January, five months before the UK announced an end to onshore wind subsidies for schemes generating more than 5MW. The change only applies to new wind farms and not single turbines, which has helped soften the blow somewhat, according to David Gudgin, a partner at Albion Ventures: "Single turbines up to 1.5MW, especially those benefitting from previously agreed feed-in tariff subsidies, are still attractive and we plan to continue with construction."

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Representing more than a quarter of its £400m under management, renewables is a core element in Albion's strategy. Since renewable investments are now off-limits for VCT funds, the firm finances its activities in the space through the dedicated company Albion Community Power, which focuses on building and buying wind turbines, as well as hydro and biogas schemes. The deals always feature partnerships with specialised developers that build and maintain the assets. "Renewables is a specialist sector, with single-digit returns that are typically too low for private equity. To make these returns attractive requires long-term thinking, keeping initial construction costs down and increasing income over 20 years through selling the electricity at a higher price, something only a dedicated energy investor can offer," says Gudgin.

A glance at one of the latest sizable private equity deals in UK renewables confirms the bleak picture. In late October 2015, Terra Firma, the owner of a 68.5% stake in British renewable producer Infinis Energy following an IPO in 2013, announced plans to buy the remaining shares to take it private once again (the buyout house had previously taken the company private back in 2003 when it was known as Waste Recycling Group). The offer valued Infinis at £555m, down from the £780m it achieved with its 2013 flotation. In a statement, the GP attributed the slump to a "challenging power price environment" and the removal of onshore subsidies after the UK's 2015 general election.

While Terra Firma looked to the state as a cause of Infinis's woes, others in private equity have chosen to join forces with policy makers. A strategic alliance helps when navigating the labyrinthine renewables world, as proved by Denmark's Dong Energy. The group, a giant among European offshore wind players, is still very much a state affair, with the Danish government holding a 58.8% stake, while 17.9% is held by Goldman Sachs' private equity arm. A shareholder since a controversial government partial sell-off in 2013, the GP could soon make history as Dong's IPO plans, revealed last September, could lead to a DKK 60-80bn valuation, the largest seen for a Danish listing.

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#### **The grass is always greener**

While renewables appears unsuitable for the majority of private equity firms, GPs wanting to boost their green credentials should look to the broader green economy. "We believe that a portfolio based on green investments is a profitable thing to run; that premise is the heart of our company," says Ambianta's Tronchetti. "We are not here because of ethical reasons; we are here to make more money than others by focusing on sustainability."

According to Tronchetti, the key to investing in this space lies in two long-term industrial trends that shape today's economy and will continue to do so. The first is natural resource scarcity, which has intensified as world population has tripled in less than a century, and as emerging economies catch up with their western counterparts. The second is pollution, a by-product of the economic boom that troubles leaders in smog-riddled Paris and Beijing alike. Europe is poised to lead the potentially profitable fight against both trends, not least because it has dealt with them for longer than any other continent. "Europeans never had natural resources, but tapped them heavily so we had to learn how to use them wisely," says Tronchetti. "In addition, we had the industrial footprint and, unlike the US, we also had a dense population. Filters, catalysts, waste water treatment... it was Europe that came up with these things."

As a result, he adds, European companies hold the solution to resource scarcity and pollution that an overpopulated world desperately needs: "To produce the same output using less input; that is the art of sustainability and we Europeans have been training for it for centuries."

#### **The cleantech conundrum**

According to Tronchetti, GPs looking to build European sustainability exporting champions should keep an eye on the chemicals sector. Backing firms that develop the technologies chemicals businesses need to be cleaner could prove a sound move for private equity. In a recent Ambianta report, the green chemistry segment was forecast to represent \$200bn in business by 2020, with highlights including biomaterials, filtering solutions and catalysers. "Take Oskar Nolte, our last German investment," says Tronchetti. "It pioneered a water-based furniture coating where solvents went from representing 30% to 1% of the mix. Its product is not only more environmental, it is cheaper than the competition's."

Chemistry aside, Tronchetti points to resource-inefficient food producers, power producers and freight transporters as green hotspots.

Daniel Koppelkamm, a principal at Jadeberg Partners (formerly Mountain Cleantech), believes investment in cleantech works, provided GPs stick to two principles. "First, stay away from early-stage cleantech. It is too capital-intensive, technology risk tends to be high and businesses take very long to scale up," he says.

For Koppelkamm, it is best to sit back and let subsidies and state-backed investors take cleantech startups to the point where revenues are being generated: "Once they are profitable, once they get to the stage where they could grow out of their own cashflow, then you step in and accelerate that growth." And growth seems highly achievable judging by the 67% IRR Jadeberg reaped when it sold its minority stake in German resource and energy efficiency specialist Grünspar in 2015, just two-and-a-half years after its initial investment.

Second, some cleantech segments represent a better fit for private equity than others, Koppelkamm says. With plans to launch a third fund before year-end, Jadeberg seeks DACH-headquartered resource efficiency, industrial automation, advanced materials and precision farming companies, among others.

Look out for the second instalment tomorrow, which discusses ways to improve the green credentials of existing portfolios, and reveals LPs' stance on the matter.



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## About The Author

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José Rojo joined *unquote* in March 2015 and has since followed the private equity market in France and the Benelux. Prior to his current role, he worked for Spanish news agency Europa Press, online newspapers, foundations and acted as correspondent for the Nordic countries during a one-year stay in Helsinki.

Having graduated from Madrid's Complutense University with honours in July 2014, José is a certified speaker of Spanish, English, French and Swedish and a published outdoors and nature photographer.

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