# TACKLING CONTROL ISSUES IN RENEWABLES

UNLOCKING NEW SOURCES OF PASSIVE CAPITAL CAN HELP OWNERS AND OPERATORS TO RETAIN CONTROL OF ASSETS AND ACHIEVE PROFITABLE GROWTH IN A HIGHLY COMPETITIVE MARKET.

RealPort

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# EXECUTIVE SUMMARY

In this whitepaper, we will look at three of the biggest challenges faced by renewable energy owners and operators in Europe. These challenges are managing wind and solar farms profitably when assets are becoming more expensive;  raising capital on favourable terms to reinvest in growing their portfolio; and modifying business models so they can maintain a competitive edge in a fast-changing market.

We examine how clashes about control can hold back companies that are seeking to address those challenges, and then look at how unlocking new sources of passive capital at an asset level can be a solution.

We draw on our in-house RealPort expertise, as well as insights from other players in the renewables market. These include speakers at our virtual roundtable, ‘Industry Perspectives on Value Creation’, that we held on 19th November 2021.

# INTRODUCTION

Companies in the renewable energy sector often hear that the rise of wind and solar is unstoppable. But in some ways the industry is still driving with the handbrake on.

For example, there is massive demand from investors for wind and solar projects in Europe. This has only increased over the last two years as renewables have been seen by investors as a future-proofed asset class during the Covid-19 pandemic.

But problems with permitting of wind and solar farms in much of Europe means the supply of assets is failing to keep pace with demand, and prices are rising.

This lack of supply means the European Union is likely to fall well short of its long-term renewable energy commitments. In July, WindEurope highlighted how countries in the EU would need to install 30GW of new wind farms each year in the rest of this decade to reach the EU's target of 451GW of wind by 2030. However, they are only set to deliver half of that – 15GW per year – between 2021 and 2025.

The mismatch between supply and demand is causing challenges for asset owners and operators.

One challenge is that high valuations will raise the pressure on acquiring asset owners and managers to increase the amount of power and revenue the assets generate, so they can achieve expected returns. This means looking to raise 'capacity factors' or 'effective load carrying capabilities', and spending more on smart technology.

Owners may also face challenges when raising capital to reinvest in growth; and when they are planning their long-term strategy in a sector that is rapidly evolving.

We look at each of these in this white paper and explain how they lead to challenges around the control of renewable assets. We will also consider challenges faced by investors that may be looking to buy stakes in those companies' assets.

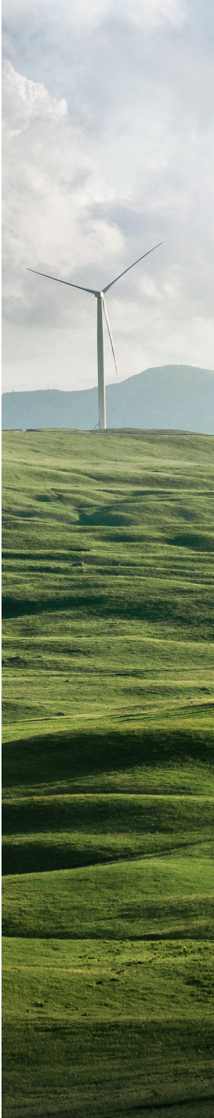


Photo by Appolinary Kalashnikova

Finally, we explain why unlocking new sources of passive capital at an asset level could help owners to mitigate these issues.

**STRUGGLE FOR CONTROL**

There are many types of owners and operators in the wind and solar sectors. These companies will experience challenges with control to varying degrees.

Technical asset managers focus more on the physical performance and operational strategy of the assets and the steps they can take to improve it. They need to keep control over operations at their assets.

Meanwhile, fund managers need most control of the financial strategy. This includes how best to balance revenues from sources such as corporate power purchase agreements and from the sale of power in merchant power markets.

Utilities and fund managers may also face more pressure to grow their operational portfolios while retaining control and the ability to consolidate; while developers may need to look the closest at getting the right capital structure early on so that they can maximise their divestment options later.

The pressures will differ but, as we will see in this report, the struggle for control of assets is a challenge for all.

However, many of these companies are also well-placed to grow due to the potential expansion of renewables.

The 197 countries at the United Nations COP26 talks in the UK in November signed the Glasgow Climate Pact, which calls for a rapid expansion of renewables, and the phase-down of fossil fuel subsidies and coal.

This shows that while there may be short-term challenges, there is also a massive opportunity for the owners and operators that can grow most successfully. Tackling control issues to ensure profitable growth makes sense in such a scenario.

CHALLENGE 1:

# MAXIMIZING OPERATIONAL PROFITS AT ASSETS

Photo by Appolinary Kalashnikova

There is huge investor demand for the renewable energy assets in the market. Total investment in the energy transition hit $755bn in 2021 according to Bloomberg New Energy Finance, while investment in new renewables grew 6.5% year-on-year to hit $366bn in 2021. The appetite for renewables has grown in 2020 and 2021 as the renewable energy sector has been seen as a haven for investors, and we expect this interest to continue in 2022 and beyond.

However, this huge demand is not wholly positive for owners and operators. Demand for renewable energy assets is high, which is pushing up prices and squeezing profit margins. This is increasing the pressure on asset owners such as fund managers and utilities – and any companies they have acting on their behalf – to ensure projects are working as efficiently as possible to boost production and returns.

**WHY IS THIS A CONTROL ISSUE?**

Asset owners want the freedom to implement operational and financial strategies so they can maximize the value of their wind or solar farms as they see fit. However, this ability can be compromised if they have the wrong ownership structure.

## CHALLENGE 1: MAXIMIZING OPERATIONAL PROFITS AT ASSETS

Owners and operators gain the most control over how their assets are run by owning them outright, but this isn't always desirable or possible. In some cases, they have a gap in the capital stack that needs to be filled. Asset owners may look at mezzanine or equity financing as they are restricted in their investment mandate to acquire new assets and consider diverse financing options.

In other cases, they may want to sell a minority stake to improve the project's internal rate of return or make investor distributions, for example.

In both situations they have two main options.

The first is to bring in active investors with experience in renewables that want to be involved in day-to-day management of assets. The second is to bring in one or more passive investors with less experience of renewables. Typically, those in this latter group do not want to be involved in day-to-day management, so will let the operator lead the way.

This is an important decision for owners that want to retain operational control of their assets so that they can run them in a way that maximizes their profits.

Ranjan Moulik, director and chief consultant in global financial services at K2 Management, said that operational control has always been a factor of such deals, but has been a bigger talking point in recent years.

Photo by Andrea Boldizsar

"It's supply and demand," he said. "What I have seen over the last two or three years is, when someone is selling a project, two things are extremely important to them. One is the price buyers are willing to pay, and the second is what are their demands for control. There is a lot of discussion about that during the negotiation."

This competition between potential buyers could give sellers more leverage in their negotiations, including over the level of control they hand over to buyers.

Ultimately, owners and operators need freedom to manage day-to-day operations at wind farms and solar farms so they can maximize profitability in an increasingly complex and competitive marketplace. If they hand over too much control of their assets in their desire to optimize the capital structure, then their ability to achieve these profits may be diminished.

## CHALLENGE 2:

# SELLING PARTIAL STAKES TO RECYCLE CAPITAL

The limited supply of renewable assets in the market also leads to fierce competition for the assets that are available. This means that developers, fund managers and utilities are exploring many avenues to see how they can fund the development and growth of their portfolios.

One way to do this is selling partial stakes in operational assets or portfolios. They can then re-invest that capital and their know-how to develop new assets.

In one respect this is straightforward. There is no shortage of potential investors that want to buy partial stakes in renewable energy assets, and so raising capital should be straightforward.

The challenge for the 'equity recyclers' is that they don't agree to sell partial stakes in a way that hinders what they can do with an asset later. Higher asset valuations puts them under increased complexity to deliver returns, and therefore means that there is a greater need for strategic alignment and good governance in their partnerships.

Failure to achieve that alignment can be problematic. For example, they could link up with an investor with a different long-term strategy, or they could hand over rights that lessen their control when it comes to sell their majority stake. This would make it harder to expand by recycling capital.

**WHY IS THIS A CONTROL ISSUE?**

The renewable energy market is increasingly complex. Factors such as the rise of merchant risk, evolving deal structures, and the need to boost operational efficiency mean that owners and operators need to be strategically aligned with their investors – assuming they cannot own and control the asset outright.

If owners and operators do not achieve this alignment then it can cause challenges when it's time to exit assets. One of these potential areas is 'tag-along rights'.

'Tag-along rights' are clauses that are agreed in the sale of a stake in an asset that give minority stakeholders the same rights as majority stakeholders if the majority stakeholder wants to sell out of an asset. Investors vary widely in the

Photo by Jason Blackeye

demands that they will make of owners and operators when they are buying a minority stake.

Savvy investors will insist on rights that protect their minority ownership, such as stipulations around power purchase agreement (PPA) availability and warranties. This can protect them if the majority owner pursues a strategy that the minority owner does not agree with, but can also cause disputes over control of assets.

However, fundamentally, arguments over control can be mitigated if there is strong alignment between companies about how the assets are to be run and sold.

In a rapidly evolving and complex renewables environment, partners must be fully aligned on their appetite for risk in terms of contracted versus merchant

revenue; their capabilities; and the technologies they need to manage those risks.

The dearth of enough high-quality new assets in the market comes at the same time as high number investors want to get in. This could tempt owners and operators to do deals with investors with which they are not strategically aligned.

One investor we spoke to highlighted that there can be a knowledge gap, which can lead to problems if companies do not agree on the direction of a project.

“Let’s say you’re a family office with two to three professionals, and you’re talking to an experienced operator. There is a huge discrepancy with regards to the knowledge of the sector and negotiating these contracts, so I could see the attraction for a family office just to go with a big name without having these protections. It might work and it might not,” he said.

This alignment is important for owners and operators, because partnering with a minority stakeholder can be problematic if they have different visions for a project.

Anthony Marsh, a portfolio director in the renewables sector and the former chairman of the investment committee of the UK Green Investment Bank, said he found selling minority stakes in assets “time-consuming and difficult” because it raised questions of how to manage minority stake owners and what protections they would receive. This can come at the expense of “the flexibility to move and consolidate and grow”.

## CHALLENGE 3:

# EVOLVING BUSINESS MODELS

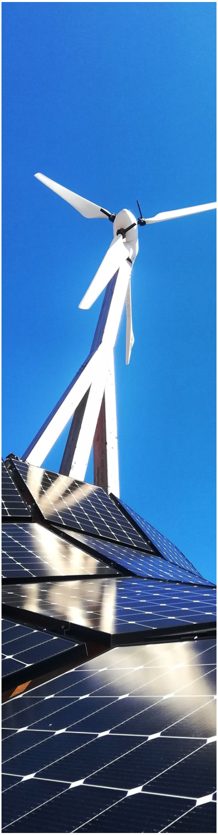


Photo by Nazrin Babashova

Increased competition for operational assets and development delays in many key European markets are forcing companies across the renewables sector to evolve their business models. These development delays are a long-term concern caused by slow permitting processes and bureaucracy, and have been exacerbated by the disruption to supply chains caused by the Covid-19 pandemic.

For instance, fund managers are increasingly looking to get involved earlier in the development cycle so they can identify project opportunities early, with the higher risks and returns that it brings, and exert more control over the assets they can add to their portfolios later. This gives them longer-term certainty, and also arms financial investors with more knowledge about how to run operational assets.

Meanwhile, growing numbers of developers are acting more like independent power producers by holding onto operational assets for longer, so they can take advantage of additional 'yield compression' for having generated stable revenue streams offered by these assets. This means that developers want to ensure they continue to have a say over how these assets are operated.

We are also seeing more consolidation as utilities and large financial players buy out smaller developers and independent power producers who can grow their portfolios in a highly competitive market. Changing ownership structures can bring control issues to the forefront.

These strategic changes mean that owners and operators need capital to help fund their growth while keeping control and consolidating assets on their balance sheet.

# CHALLENGE 3: EVOLVING BUSINESS MODELS

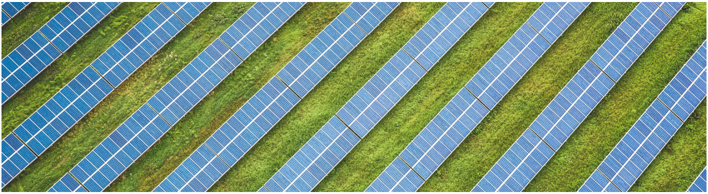


Photo by Markus Spiske

### WHY IS THIS A CONTROL ISSUE?

The renewable energy market is changing fast. Companies are responding to these changes by adapting their strategies, and they want the control to help them do this. This can lead to conflicts between owners, operators and investors about how their current assets are run, particularly with how long it takes to bring new assets online.

Some of these conflicts around control can be managed by finding a like-minded partner business, and supporting the partnership with strong governance.

"Between the professional investors, it is about finding counterparties that align with your strategy with regards to merchant risk as well as with issues like operations and maintenance," one investor said. "The name of the game in my eyes is finding like-minded investors, as that makes the negotiations about what is agreed and what is allowed significantly easier."

This can include break clauses that enable the operator to revisit the protections in the contract when the alignment agreed previously no longer exists.

Detmar Loff, partner at law firm Ashurst, said one way to ensure strategic alignment between different parties – and reduce disputes around control of assets – is strong governance over what a majority owner can do. He said 'governance' is the part of ESG (environmental, social and governance) that can get forgotten, but it is crucial to hold owners of majority stakes to account.

"Governance is about more than just documentation. It is about how the whole firm… will structure and live the values that are then documented," he said. This can help ensure that majority and minority owners are aligned even as the market evolves.

Photo by Sander Weeteling

# WHY RENEWABLES NEED NEW SOURCES OF PASSIVE CAPITAL AT ASSET LEVEL

This white paper has so far looked at the challenges with control of assets that are faced by owners and operators in the current market. They are:

- managing wind and solar farms profitably when assets are becoming more expensive;
- raising capital on favourable terms to reinvest in growing their portfolio; and
- modifying business models so they can maintain a competitive edge in a fast-changing market.

One potential solution to the control challenge comes if we can unlock sources of passive capital that have not previously invested in wind or solar. These investors are likely struggling to get into the sector due to the imbalance of supply and demand, as well as being reticent about taking on the day-to-day management of renewables assets.

Photo by ZHANG FENGSHENG

Specifically, we mean smaller institutions, which have less than $2bn of assets under management, and family offices that invest on behalf of high-net-worth individuals.

Research shows that these investors have historically been reluctant to invest in renewables but will now do so to boost their environmental credentials, and because more are convinced by the long-term credentials of renewable energy.

These are attractive partners because they do not want to have responsibility for the day-to-day operations of projects. This can enable owners and operators to:

- Retain day-to-day control over operations and maintenance of assets so that they can maximize energy production and optimize their financial returns.
- Sell partial stakes at project or fund level while ensuring they retain control over what they can do with the stakes they retain. This helps the owner to recycle equity and grow their portfolios.
- Adapt their business models to respond to continued evolution of wind and solar markets, in a way that minimizes chances of conflict with other firms.

**HOW BIG IS THIS OPPORTUNITY?**

These passive investors have historically been reluctant to invest in wind and solar, as we can see in the International Renewable Energy

# WHY RENEWABLES NEED NEW SOURCES OF PASSIVE CAPITAL AT ASSET LEVEL

Photo by Rabih Shasha

Agency's 'Institutional Capital' briefing document that was published in January 2020. IRENA analysed deals data and found smaller institutions have historically been slow to invest in renewables.

IRENA analysed deals data from Preqin about "deals done" by 5,800 institutions in the two decades to the middle of 2019. It found that 37% of institutions had invested in infrastructure since 2000; 25% in energy funds; and only 20% in renewables-only funds. Four out of five investors ignored renewables funds during that period.

Moreover, it found that the institutions that had invested in renewables were usually larger global players. IRENA said the institutions that invested in renewables funds had on average $30bn assets under management (AUM), compared to $12bn AUM across its sample group.

This shows that the smaller institutions have been slower to get into renewables than larger counterparts such as BlackRock, Brookfield or Macquarie.

Finally, it found only 2% of insurers and 1% of pension funds had invested directly in renewable energy assets over that period. This shows there is an untapped market, and that companies in the renewable energy sector can unlock this capital if they can provide models that enable these investors to invest in a low-risk way.

## WHY RENEWABLES NEED NEW SOURCES OF PASSIVE CAPITAL AT ASSET LEVEL

Owners and operators in the renewable energy sector can tap into these sources of passive capital if they can provide management expertise to optimize production at their wind and solar assets, while also having the strategic alignment with passive investors. This strategic alignment enables the majority owners to retain broad operational and financial flexibility, while the passive investors will gain confidence to invest with partners that have 'skin in the game' (i.e. own majority stakes).

IRENA also highlighted that co-investment structures were an attractive way to bring more investment for the energy transition, in a report called 'Mobilising institutional capital for renewable energy' that was published in November 2020. This can help owners and operators to expand their available sources of capital by attracting foreign investors that they may not otherwise be able to successfully attract.

# HOW REALPORT CAN HELP FACILITATE THESE DEALS

Our belief at RealPort is that unlocking these sources of passive capital can support the acceleration of the energy transition, while giving owners and operators control over how they release and deploy capital at their assets.

Our digital brokerage platform enables owners to sell minority stakes in renewable assets at project level in a way that offers strong control for asset owners looking to tap into new sources of passive capital.

RealPort aggregates smaller co-investors and acts as a single interface to asset owners, offering services including transaction and subscription management; compliance checks; and reporting. We do this with state-of-the-art digital technology that enables us to scale across hundreds of individual investors.

## HOW REALPORT CAN HELP FACILITATE THESE DEALS

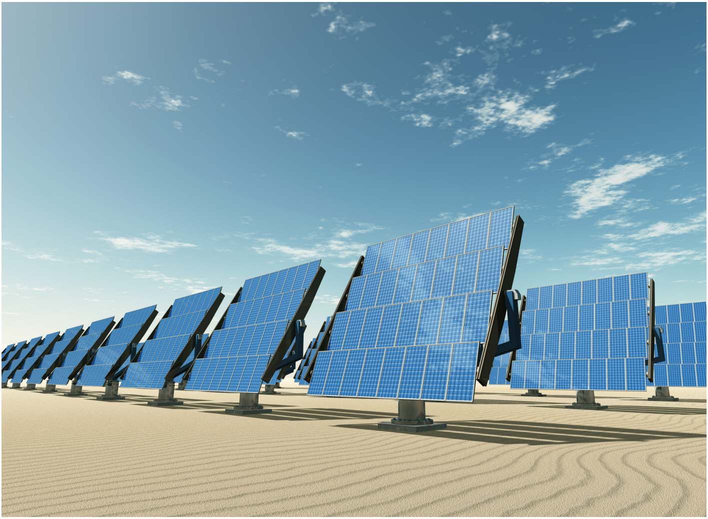
This approach offers two main benefits for owners, which are able to benefit from a competitive risk-adjusted cost of capital. Those benefits are:

- Control: - Working with smaller co-investors helps asset owners to access and aggregate a fragmented source of capital that they can then recycle into new projects. A pool of co-investors means that the owner doesn't need to cede control over their assets, while the co-investors will enter these deals happily so that they can gain bite-sized exposure to cashflows in renewable energy.

- Speed: The fact that owners are not sharing control of assets gives them more say over how they are managed and helps be more entrepreneurial, and the co-investors also benefit from the owner pursuing this agile approach.

In short, we see those types of passive investors should be comfortable forgoing governance rights as long as they are confident the operator they are working with can deliver the value they promise.

They can gain this confidence with manager- and asset-level assessments carried out by professional third parties with deep sector knowledge, and transparency from operators. This gives these passive investors the peace of mind that the operator complies with all relevant regulatory requirements and has a strong track record of running profitable assets in the renewables sector.



## SUPPORTING THE TRANSITION

There is currently huge competition for renewable energy assets in Europe, which is being exacerbated by permitting problems and is limiting the supply of new projects and investment opportunities. In wind, for example, the continent is on track to build only half of the 30GW it needs annually by 2030 to hit its green targets.

We see little indication that this imbalance will change soon. This means owners and operators will need to keep finding ways to fund and manage assets as profitably as they can, including by potentially incorporating technology such as energy storage. That is one emerging area where companies will want to ensure they are aligned.

Control will be crucial in these companies' asset management strategies.

Meanwhile, new sources of passive capital will continue to struggle to start investing in wind and solar assets. Demand is likely to continue outstripping supply, and so it will be a challenge for smaller investors or family offices to get into the sector. We believe they will want to work with owners and operators that can demonstrate that they have a track record of successfully delivering profitable projects.

The renewable energy sector in some European markets is currently driving with the handbrake on. The approaches outlined in this white paper help owners, operators, and new types of passive investor to thrive despite current market challenges.

RealPort believes that by unlocking a vast pool of passive capital, we can make a significant contribution to driving forward the energy transition.

*RealPort is an investment brokerage platform that aims to create global tradability for sustainable alternative assets. RealPort enables asset holders to partially divest positions in operating renewables assets, while empowering small institutional investors to build and divest bite-sized positions in single assets. RealPort is unique in automating compliance requirements as well as transaction and settlement processes. The company combines a flexible structuring platform with an innovative digital issuance and securitisation infrastructure, thus enabling asset holders (issuers) and investors to significantly reduce transaction cost and time.*

**RealPort**
**Lennéstraße 5, 10785 Berlin, Germany**
**Email:** market@realport.co
**Web:** realport.co

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