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Part five of an on-going series

The long and short of it is good projects do get funded, but it's not easy

Tuesday, 03 April 2012

Dan McCue

Like the expression "all the good ones are taken," the proposition that all good renewable energy projects are bankable is both vague and frustrating.



Who among us hasn't at one time in life or another asked ourselves, "How can it be that my timing is always so bad?" or, more appropriately in this context, "Why their project and not mine?"

Hoping to get a more granular and hopefully, more useful definition of bankability, we turned to Tom Murley, who leads the renewable energy team, at HgCapital, the first significant private equity firm in the UK to establish an investment team dedicated to the sector --way back in the halcyon days of 2004.

The firm went on to raised its first renewables dedicated fund in 2006, following what its website describes as " two years of deep sector research."

Murley himself, however, has more than 15 years experience in providing equity finance to the US and European conventional and renewable power sectors.

He was formerly co-head of Allianz Private Equity's renewable energy team and previously with the EIF Group.

In addition to his duties at HgCapital, where he is responsible for HgCapital Renewable Power Partners' funds, Murley is Chairman of the British Venture Capital and Private Equity Associations board on Sustainable Energy, Environment and Technologies.

The American attorney, who holds degrees from Northwestern University and Fordham University School of Law, also sits on the Economics and Markets Committees of the British and Swedish Wind Energy Association.

So we put it to him, "What's bankable?" And, "Just how bankable do people believe renewable energy projects are right now?"

"Well, just as in the case of conventional energy projects, good renewable energy projects will be bankable, given certain markets," Murley said. "So, if you've got a good sponsor, good equipment, a good equity owner, an operating history in the resource, and it's going to work, then you should have every expectation of finding your way to funding.

"The issue now is the stability of the regulatory regime," he continued. "Italy at the moment is probably off limits for new deals. Greece is... forget it. The US, I think, will have a decent year, but absent an extension of the regulatory regime in the US, it is going to taper off.

"But the long and short of it is decent projects do get done," Murley said. "I think what's happened is the standard for what people consider 'bankable' has changed a lot in the past three to four years. I can say this from a European perspective, three years ago, four years ago, you could almost be anyone showing up with a wind farm and get it financed, particularly in Germany, Spain, various places. And as for the financing itself, sometimes you'd find 90

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percent to 100 percent debt financing. However, that was an aberration. That was never sustainable."

Today then, projects require much more equity -- Murley suggested leverage has returned to "more normal levels" of 70 percent to 80 percent -- and banks are being more selective about the quality of projects they sponsor.

They not only want to know who's developing the project and who's going to own it, but also, who's going to take care of it over the entirety of its long life.

"The other thing we can say is that following the collapse of Lehman Brothers in 2008, in Europe, at least, bank lending for renewable energy projects was the last lending sector to close in the fall and winter of 2008, and it was the first area that banks started lending again in mid to late spring 2009," Murley said. "When banks were laying off their mortgage staff and other investment banking teams, they did not cut back on their utility or their renewable energy finance staffs in Europe. So that kind of tells you there has been a residual appetite.

"But it's harder to thread the needle than it was before," he added. "That said, I think it had gotten too easy."

It should be noted that there's a difference between banks and funds, and to make a project work, you need both.

"Looking at it from a European perspective, funds like HgCapital generally invest in equity, while banks provide the long-term debt. Banks generally don't do funds and they generally don't invest in equity. And you need debt and equity to make these things work," Murley said.

"[As regards funds], I guess there are a couple of post-Lehman trends that are kind of still playing out -- if you go back to 2010, roughly speaking, and look at global clean-tech investment and where it came from, about 21 percent came from public pension funds, about 18 percent came from fund-of-funds -- which are funds that invest in other funds and are generally backed by public pension funds -- about 10 percent came from banks, nine percent came from private and corporate pension funds, and seven percent came from family offices and foundations.

"The balance came from corporations, insurance companies, university endowments and sovereign wealth funds," he said.

"Now, if you look at those investors today -- and this would apply for a private equity fund, an infrastructure fund and a clean-tech fund -- banks are doing less, largely due to the Volcker rule and other capital-related issues," Murley said.

The Volcker Rule is a specific section of the US Dodd-Frank Wall Street Reform and Consumer Protection Act originally proposed by American economist and former United States Federal Reserve Chairman Paul Volcker to restrict United States banks from making certain kinds of speculative investments that do not benefit their customers.

The net result of these issues is that right now, banks simply don't have the money to make investments in renewables like they used to. As a result, Murley said there's likely to be rather more investment on the part of investors like public pension funds and sovereign wealth funds.

"At the same time and at the moment, private pension funds are neutral, insurance companies are neutral to decline, and that's particularly true in Europe because they are subject to the Basel III regulations," he said.

Basel III is a global regulatory standard on bank capital adequacy, stress testing and market liquidity risk agreed upon by the members of the Basel Committee on Banking Supervision in 2010.

In practice the regulation sets standards for capital conservation and buffers to risk exposure, theoretically making for there being more stable cash on hand at any given time.

"Also in decline in terms of investment are fund-of-funds, because there's a kind of dual fee thing going on there -- you pay then fund-of-fund manager and then the individual managers of the respective funds --financial institutions like banks and the like are clearly on decline, and university endowments in America are investing less, although they were probably over-allocated, generally, to private equity and the like."

Based on that overview what's clear is that the appetite for renewables investment on the part of funds is clearly different than it was just a few short years ago, and there's also much less liquidity in the market.

"What happened in both the infrastructure area and in private equity, there was a boom from 2003 to 2008, when people were investing in businesses, selling them on pretty quickly, returning money to investors, and this was a great deal," Murley said. "In that environment it was, 'I gave you \$50 million last time around, I'll give you \$100 million in the next fund.' Then, basically, what happened in 2009 is all these sales stopped, so the investors weren't getting any money back, and as a result, there's been no recycling of money, so to speak, to feed the ongoing raising of funds."

While there was an uptick in investment activity in 2010, is ratcheted down again in 2011, and those hopeful that recovery was at hand were spooked by political gridlock, policy upheavals and rapidly fluctuating energy costs, among other factors.

"In that context, renewables have to compete against other investment opportunities in a market that is simply less liquid, has less capital around, and from investors who are looking ever-more critically at which investments they are going to make."

Against such a backdrop, government policy is an absolutely critical determinant of whether investment will be fostered or allowed to founder.

"Regulatory risk is the number one risk for renewable. What I've seen in speaking with investors over the last 18

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months is you can kind of put it into three categories," Murley said.

"US investors are worried about Europe, so they are not coming here. If the Euro is going to implode, why would we want to be part of that?" he explained. "This looks messier from the United States, so we've seen a big decline in US investors and the US institutional investment market is the deepest in the world."

"In Europe the investors tend to be more focused on the terms and the cost of their investment management, so they are squeezing fund managers to reduce fees and costs dramatically" he continued. "At the same time, Asian investors -- and this is from a European perspective -- are really not focused on investing in European renewables."

"Everyone, absolutely everyone, is worried about regulation and whether there are going to be retroactive changes, like we saw in Spain," Murley said. "The questions you hear, 'Will they cut it so that it is not profitable?' or 'Will they abandon the programs because of the austerity measures that have to go on in Europe?' So everyone is worried about that."

In such an environment, investors have been concentrating on buying existing and operating renewables projects from people who suddenly find they need to sell them. The money that's out there is not building new things the way that it used to.

For example, large infrastructure funds have recently purchased operating Spanish solar thermal projects, while other investors have gone out and bought operating wind assets.

"Whether the sellers recycle the money back into the sector or put it into their pockets or pay off their banks -- as the case more likely may be -- it varies or differs from market to market," Murley said. "But I'd say that probably 60 percent of investment activity in the last two years, in terms of capital, is M&A activity and is not introducing capital to build new projects."

"What we have seen in Europe is that the number of investors who are looking at the space has increased from less than 10 in 2007 to over 20 today, and what it tells me is the larger infrastructure funds -- these are the guys that raise \$3 billion, \$4 billion, or \$5 billion at a pop -- they can't go around and do a 10 MW solar project that requires a \$10 million check. It's not efficient for them," he continued. "What they want to do is build bigger operating things and bigger transactions, so we're seeing people beginning to assemble groups of assets that are attractive to them. The exception is the case of solar thermal, where the checks are big enough for investments to be attractive on a primary basis. So the lesson there is you have to think of scaling up to attract the interest of the general infrastructure funds."

"The second thing is, returns are becoming more attractive," Murley said. "Frankly, the whole sector was overpriced in 2005 to 2007 and a lot of people, including us, just didn't do a whole lot of investing because the price expectations were just crazy. Now prices have moderated, so it makes it a bit more attractive."

Inevitably the question one comes around to is what the biggest investment plays are right now.

According to Murley, the biggest opportunity for investors is offshore wind, but it is also the most expensive and requires the most capital.

"And fundamentally I think the biggest issue there is people are being asked to take very substantial risks whether construction or operational, that they are just not ready to take," he said.

"The conundrum we have right now is on the construction risk... utilities are being forced to do it on balance sheet while they are constrained, so there's a natural limit and I don't see investors moving aggressively to take on the construction risk. The number of people willing to take that long term operational risk is growing, but it is still small... which is a long way of saying we need more track record on building and the performance of these assets over time before we see a lot more capital flow in that direction."

"We are probably in version 3.0 of offshore wind," Murley continued. "Version 1.0 was a disaster, version 2.0 was a little bit better, but the returns didn't justify the risks, and we're sort of getting started on 3.0, so the jury is still out on that."

"On solar thermal, that market is effectively a Spanish market, and I think it is closing down," he said. "The Spanish government had rationed how much solar thermal they want and they are going to get to that point soon and I don't see anyone following that in Europe."

In Murley's view, solar PV will continue to decline as a market as governments seek to cool what had become an over-heated market and allow its future deployment to sink lower on their agenda.

"There's still some interest in onshore wind, and investors are pretty comfortable with that, and there's also some interest in investing in hydro," he said.

What of wave and tidal energy?

"That's a technology that's still in its early, seed capital days," he said. "It's not happening yet in terms of large-scale investment."

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