Renewable energy investment trends in Europe

SIMON EAVES, BARNEY COLES AND DARIO BERTAGNA OF CAPITAL DYNAMICS DISCUSS THE PROFOUND CHANGES EXPERIENCED BY GLOBAL ENERGY MARKETS OVER THE PAST YEAR, ANTICIPATING SIGNIFICANT FUTURE OPPORTUNITIES FOR RENEWABLES IN EUROPE

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The last year has been unlike any other. It started with a stark reminder of the devastating impact of climate change and became engulfed by a global pandemic that will forever define the year. Addressing the broader impact the pandemic has had on the world, and how one moves forward from here, is more suited for other commentators and beyond the scope of this article. Instead, we will share our perspective and insights on how the last year has profoundly influenced the global energy infrastructure landscape, and the renewables markets specifically. In addition, we will discuss why there is reason to be optimistic about the significant opportunities for renewables in Europe.

Lessons learned

As bleak as things appeared to be in the early months of 2020, we witnessed a remarkably fast turnaround in market conditions by early April. Aggressive action on fiscal and monetary stimuli across Europe stabilised markets, and the broader sense of panic began to recede. By May, the credit markets were functioning again, albeit not all institutions recovered at the same pace. Eventually, and in a remarkably short period of time, the entire investment process from investor commitments to project investments migrated online and people became more comfortable working in a "virtual" world.

As the infrastructure market sprang back to life, it became clear that investors had to look at risk in a new way. Some traditional infrastructure investments linked to GDP were experiencing drops in value well beyond any previous downside case, which was particularly true for transportation assets. Meanwhile, telecom assets saw a dramatic rise in value as the whole world increasingly relied on digital communications. The renewables sector, by contrast, remained stable, with the value for highly contracted assets staying constant, and only minor delays occurring in construction processes. The pandemic re-enforced the understanding that renewable assets are highly uncorrelated to GDP and other asset classes. Investors looking for assets that have resilience throughout the pandemic can look to

contracted renewable projects as a stable (and yielding) alternative.

Renewables set records in 2020, adding nearly 90% new renewable power capacity globally. We expect the secular changes taking place in the power market with the energy transition not only to continue, but to accelerate as we look ahead.

The steady performance of the sector, increased focus on ESG, and the desire to invest in themes supported by governments globally has led to greater investor interest in renewables. This has resulted in more managers entering the space for the first time, and we believe that this influx of new managers has created new risks for investors. While many managers have deep experience in broader energy markets or other forms of infrastructure, very few have the combination of existing scale, experience and truly proprietary sourcing capability in renewables. As expected, we have noticed an excess of equity flows towards the easiest entry points in the renewables sector. Accordingly, we believe it is important to move away from these overcrowded segments of the market and direct more focus on proven, harder to replicate strategies that can offer more upside as well as longer-term offtake contracts.

Key themes for 2021

2021 is shaping up to be the beginning of another very exciting period for renewables in Europe. However, as highlighted above, with the maturing of the industry, deep and focused expertise will be required to achieve success.

1. **Growing momentum will continue to drive the European energy transition**
   With ambitious coal retirement targets and a strong stance on climate change, we expect Europe to continue leading the global energy transition. European countries are accelerating coal phase-outs through legislative targets, while the UK is targeting to fully phase coal out within the next three years. Furthermore, emissions limits are forcing coal operators to upgrade equipment or retire, while nuclear capacity growth is projected to remain soft as older plants close and new capacity plans stall.

   Industry experts estimate that renewables will supply in excess of 80% of European electricity by 2050. Declining technology costs continue to improve the competitiveness of renewables against conventional alternatives, and falling costs of battery storage (accelerated by the growth in electric vehicles which could make up over half of passenger vehicles by 2032) will allow increasing capacity of larger renewables assets to provide base load power.

   The momentum behind renewables is further enhanced by the surge in multinational corporates seeking to fulfil 100% of their long-term power requirements from renewable sources. The Climate Group's RE100 membership continues to rise and now numbers over 280, and corporate demand for renewable energy is likely to increase further, with household brands announcing their commitment to sustainability. Value can be generated by sourcing long-term contracts that match these large corporates to deals accessed directly from developers. Such contracts with creditworthy counterparts provide a guaranteed contracted price, cushioning the assets against market turmoil, and providing long-term, de-risked cash flows for the entire contracted period.

2. **The policy environment will remain accommodating**
   Governments across Europe continue to signal strong support for renewables. In the UK, the Prime Minister set out a ten-point plan for a green industrial revolution to "Build Back Greener" through clean wind energy – creating jobs, slashing carbon emissions and boosting exports. In the EU, various green stimuli packages were announced totaling tens of billions of euros to support a sustainable recovery and to continue its drive towards the Paris Agreement target of net zero emissions by 2050. Decarbonisation of European energy supply will be crucial to achieving these targets.

   A) Broad shift towards 'softer' incentive model
   For nearly two decades, the European renewables market has benefited from attractive state subsidies, which has encouraged significant levels of investor capital to the sector and brought the industry, at large, to maturity. Fast-forward to today, and technology costs have fallen to a level where high quality and efficiently operated projects can now compete with more conventional forms of power generation without the need for subsidies. In response to these changing economics, state governments have begun to reassess traditional subsidies in favour of "softer" measures, under the auspices of the European Green Deal, such as a more accommodative local permitting environment, wider grid infrastructure upgrades, and local tax incentives. Understanding how these shifting incentives will impact clean energy markets, in tandem with technological expertise, price hedging

capabilities and operational efficiency, has become increasingly important to securing and delivering attractive investments in this new landscape.

B) Brexit clarity
In December 2020, within days of the transition period deadline, the EU and UK agreed to a new Brexit deal, removing an overhang of significant uncertainty, and therefore volatility, from the market. Specifically, the deal moderated severe fluctuations in the currency market and provided the requisite framework to secure the energy supply in both economies. It also included an ambitious agreement for cooperation on clean energy and climate change, with large penalties if either economy breaches its commitment to the Paris Climate Agreement. Furthermore, the UK and EU have similar agendas in developing the North Sea as one of the world's key centres for offshore wind. The new Brexit deal is viewed as a net positive for investing in the UK and EU.

3. **Specialist knowledge and relationships matter**
As the corporate PPA[1] market continues to evolve in Europe, and interest in the utility PPA market continues to grow, high quality long-term power purchase agreements represent the most attractive solution to hedging long-term power price volatility. With each European country in a slightly different stage of their market transition journey, only a specialist investor with regional expertise is able to access the most attractive market-specific opportunities and negotiate optimal structures.

ESG focus

Carbon emissions peaked at record levels in the past year, with an increasing number of devastating climate events witnessed globally. The need for clean energy is marked and the recently announced EU SFDR regulation will require further transparency and reporting from market players.

As awareness of the risks associated with climate change grows, and social events globally highlight the need for managers to have sound ESG frameworks, we expect investors to look more closely at ESG policies and how frameworks are implemented across portfolios and through the entire lifecycles of our projects. A number of new ESG players may enter the market promoting new ESG-compliant funds, but it is believed there is a significant first-mover advantage for those firms who have been longstanding proponents of good ESG practice and have a deep understanding of how to make a real difference here.

Conclusion

To put it simply, the outlook for renewable energy infrastructure is bright. Despite challenges brought on by the worst of the pandemic thus far, this industry has navigated how to operate and succeed within this new paradigm. For long-term, specialised renewables investors, this is a pivotal period where value can be prudently extracted for investors while building a greener, more sustainable future. The last five years have been exciting, but with support mounting from governments, corporates, utilities and private markets, interest in renewables will continue to accelerate.

1. Power purchase agreement