Renewable energy investment supports ongoing de-carbonization initiatives and can offer an attractive range of benefits to investors seeking alternative assets, says Newton Investment Management portfolio manager and strategist Paul Flood.

For Flood, renewables can potentially provide stable long-term cash flows, with a good line of sight. Yet it is an asset class that tends to get overlooked despite being less affected by quantitative easing and zero-interest-rate policies compared to other financial assets, he says.

“As long as the sun comes up every day, you’re going to sell power for something.” In some senses, investing in renewables is like investing in bonds, except with some sensitivity to the price for generating power, he continues. Renewables can offer strong inflation protection as revenues have direct, contractual inflation obligations. In terms of renewables, Flood favors the UK as he believes that it has a “sensible” investor base that understands the asset class and leverage is low, plus there is the strong legal protection afforded by English law. There is much stronger protection around the subsidy regime than is available, for instance, under Italian or Spanish law. In the U.S., the investor base tends to be more transient and can include, among others, hedge funds with much higher levels of coverage.

Flood characterizes the U.S. market for renewables as less transparent than the UK’s and with more leverage on assets at the operating company level and that tends to contribute to additional risk. In his view, tax relief is effectively a subsidy, with the possibility of writing off assets in order to reduce the tax bill quite quickly.

The U.S. structures are much more opaque and there is a substantial number of interparty-related transactions, he comments. President Donald Trump’s administration has placed an emphasis on renewing U.S. infrastructure, but this stance is not as friendly towards renewables.

Renewables also fit in with de-carbonization and ambitions for a 2° C threshold that scientists regard as the limit of safety before the effects of climate change become irreversible, observes Flood. The Paris climate conference (COP21) in December 2015 was viewed as hastening the transition away from fossil fuels to a clean energy economy.
SUBSIDY REGIMES

In Spain and Italy, the subsidies that investors were expecting have changed and this has had an impact on returns, says Flood. This was then compounded by the fact that most of the renewable projects were locked in with quite high levels of leverage. When the financial crisis occurred in 2008 and was followed by recession, demand for power dropped dramatically, observes Flood. Spain had earned a reputation for leadership in the development of wind- and solar-powered electricity and the subsidy regime for renewables came from a contribution from electricity bills. When electricity usage went down (because of reduced economic activity), there was less money to go towards renewables and the subsidies went by the wayside. This is now the subject of a legal challenge in Spain and a similar pattern has been observed in Italy, says Flood.

Changing the historic subsidy regime can make it difficult to entice capital to infrastructure spending in the future. Flood says there is an argument for bringing down subsidies as the cost of constructing solar and wind plants as well as the provision of equipment has gone down dramatically. It also reduces the burden on the taxpayer, he notes. However, this is unlikely to affect existing projects.

SUN VERSUS WIND

For this asset class, one of the key forecast risks is the short-term variability of the natural resource’s availability. On a year-over-year basis, solar energy has been very stable, going up or down by 5% per annum in terms of output, says Flood. A clear, sunny day helps, but some 80% of the generation by a solar panel is through the dispersion of the sunlight, he adds. A significant proportion comes from the action of the sun’s rising each day.

Wind, on a daily basis, is far more variable, tending to vary by 10% from year to year, says Flood. On an annual basis, the swing in variability can be as much as 20%. Investors need to be compensated for the additional risk of the wind’s volatility and, as a result, there are higher returns from wind assets. Wind turbines—given the number of moving parts—require a lot of maintenance. Solar panels, although vulnerable to theft, require less maintenance beyond occasional cleaning, he explains.

The business plans of both developers and operators of renewable assets include assumptions on the levels of power generation, with these projections used to raise finance in the equity and debt markets. Assets are valued on probability scenarios, with P50 indicating that there is a 50% probability of the annual production exceeding the forecast and P90, a 90% probability.

In respect of renewable energy funds, Flood suggests evaluating the yield to maturity and not simply the yield in a specific year. The internal rate of return calculation takes into account the current stock price, the future dividend streams and the net present value of the portfolio over its lifetime.
BREXIT CONCERNS

As the UK embarks in earnest on negotiations to leave the European Union, there is the possibility of a resultant recession and, given the UK's large deficit and uncertainty on whether foreign investors will continue to provide capital, sterling could fall further in value, says Flood. If inflation picks up because of the cost of importing goods and services into the UK, this is likely to have a positive impact on renewable assets because of their inflation linkage. Historically, the UK has been prone to high inflation, notably in the 1970s and the early 1980s.

CORPORATE GOVERNANCE AND ESG

Solar energy can play a part in many countries in Africa as sunlight is abundant and there is a growing demand for power, says Flood.

Farms, villages and small towns are frequently faced with a lack of connectivity to the electricity grid. Building out renewable energy power sources can provide them with lighting and the ability to use mobile devices and computers, which are much needed to access banking facilities and agricultural trading. For an investor, support from the regulator is needed and the security of the assets is paramount.

Where professionals, say from the UK, provide the know-how to develop such facilities, governance would generally be high, says Flood. UK listing rules require strong governance, he notes.

This is important as a failure to meet recognized standards of good governance and to operate sustainably represents a dual threat to financial performance that, in Flood's opinion, is not adequately compensated by the expected returns. A way of assessing the overall quality of management is looking at the effectiveness of the management of the environmental and social aspects of the business.

Newton meets with the management of a company in which it is invested to raise points of concern and to discuss why the company should be concerned as well. This is a very active process that can happen over many years and Newton will hold a company to account, if necessary. It will also acknowledge if the company is acting in a way that leads its sector.
RISKS

All investments involve risk, including loss of principal. Certain investments involve greater or unique risks that should be considered along with the objectives, fees, and expenses before investing. Equities are subject to market, market sector, market liquidity, issuer, and investment style risks, to varying degrees. Investing in foreign denominated and/or domiciled securities involves special risks, including changes in currency exchange rates, political, economic, and social instability, limited company information, differing auditing and legal standards, and less market liquidity. These risks generally are greater with emerging market countries. Stocks that invest predominantly in infrastructure sectors and projects may be subject to a variety of factors that may adversely affect their development, including high amounts of leverage and high interest costs due to capital construction and improvement programs; difficulty in raising adequate capital on reasonable terms in periods of high inflation and unsettled capital markets; and costs associated with changes in environmental and other regulations. Funds that focus on a single sector or asset class may also experience higher volatility than funds that have more diversified portfolios. Socially responsible portfolios may forgo opportunities to invest in other securities when advantageous, or may sell securities when disadvantageous for them to do so while pursuing their socially responsible criteria.

An absolute return strategy is an unconstrained investment approach and performance is measured against a goal that reflects portfolio construction focused on risk management and is designed to deliver positive returns in changing market environments. Traditional "relative return" funds are managed to and measured against broad-based benchmark indices, rather than against "absolute" measures of principal risk. Absolute return portfolios may not fully participate in strong positive market rallies. Correlations measure the relationship between the changes of two or more financial variables over time. Duration is a measure of the sensitivity of the price—the value of principal—of a fixed-income investment to a change in interest rates. Duration is expressed as a number of years.

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