NextEnergy Renewables

NREN will offer investors access to the high return potential in private renewables funds...

Update
15 February 2021

Summary

NextEnergy Renewables (NREN) is a proposed investment company to be listed on the London Stock Exchange which will invest globally across the renewables energy space, investing in private funds and co-investments in order to offer a higher return potential than the existing listed renewables funds, as we discuss in the **performance** section.

NREN will target a 9-11% NAV total return, from a portfolio split roughly equally between private funds run by the manager NextEnergy Capital, private funds run by third parties and co-investments with those third parties in attractive assets or portfolios. The manager already has a seed portfolio of ten funds lined up, while co-investments are expected to follow as opportunities arise.

The targeted return includes a quarterly **dividend** worth 5.5p which is expected to grow each year. The dividend for the period from launch to December 2021 will be 3p.

NEC has a team of 200 professionals whose experience in the sector will be brought to bear on investment selection. While NEC specializes in solar power, NREN will invest in wind power, battery storage and emerging technologies such as hydrogen via third party managers who specialise in these assets.

As well as the potentially superior returns, NREN will be investing in early-stage assets, meaning it will be contributing to increase the renewables energy capacity in the global economy, as we discuss in the **ESG** section.

NREN is seeking to raise up to £300m, with a further placing programme enabling the manager to expand the size of the trust further. The intention is to use a revolving credit facility to manage liquidity when making new investments before equity can be raised. The closing date for the offer is Early March and the shares are expected to begin trading shortly after.

Analyst's View

We think NREN is a potentially exciting addition to the renewables space, offering the ability to invest in private funds which would usually be out of reach of the ordinary investor. The high return target is attractive if it can be achieved, as the expected returns on the operational funds in the seed portfolio indicate it may (see **portfolio** section). Meanwhile the diversification in the portfolio is attractive in itself, and addresses some issues of concern to investors in renewable trusts. First, the UK market is becoming increasingly crowded, with returns potentially eroding as a result. Theoretically, NREN's global remit should give it a better chance of sustaining high returns and grow the size of its portfolio. Secondly, the relatively short time horizon for the private funds and the strategy of turning over investments every 7 to 10 years should limit concerns about how long life assets are valued without any testing of the market.

Furthermore we think the **ESG** story is strong. NREN will invest in early stage projects and assets, meaning it will be helping to grow the pipeline of renewables energy supply rather than investing in mature assets for which there are no shortage of institutional or public market investors. Shares will be issued at a premium of 2% to the initial NAV, which compares to the renewables infrastructure average premium of 12%. As far as risks go, deployment risk is one to highlight. The strategy will require significant activity to identify suitable new third-party investments and co-investments, although as we discuss in the **Management** section, NEC has extensive resources to do this and the guaranteed seed portfolio will allow it to invest immediately a significant part of the IPO proceeds.

BULL

- **Strong secular growth trend to renewable energy should lead to broad pipeline of potential investments**
- **Higher potential returns from investing in private funds**
- **Global, flexible remit means returns potentially sustainable in the long run**

BEAR

- **Underlying investments will be liquid and structure is complex**
- **Manager's area of expertise is solar, although external specialists will be hired for other asset classes**
- **Investment portfolio has not yet been assembled yet, with some uncertainty over third party investments to be made**

Portfolio

NextEnergy Renewables (NREN) is a proposed investment trust to be listed on the London Stock Exchange which will invest in private funds operating in the renewables energy infrastructure space, supplemented by direct co-investments into assets and platforms. There are three proposed pillars of the strategy, each of which will make up roughly a third of the portfolio in time, although with allocations varying due to opportunity and investment timelines. NREN will invest in existing private solar funds managed by its manager, NextEnergy Capital (NEC). It will also invest in private funds managed by third party managers, which will broaden out exposure into other renewable energy sources and related technologies. Managers currently under consideration include well-established names such as BlackRock, Impax and UBS. As such, NREN will benefit from the expertise of specialist private asset management teams at the underlying fund level. Finally, it will invest directly in co-investments with the managers of those external funds as opportunities arise. Only the first two pillars will be invested in immediately following the IPO, with the expected seed portfolio as below.

The high targeted returns from these underlying funds stand out, and one of the key arguments for investing in private funds is this extra return potential. One of the factors behind this is the more patient investment strategy which sees private funds accumulate commitments and take their time to line up the right investments with attractive economics. There is more of a total return mindset than a focus on dividends, and investments typically have a 7 to 10 year time horizon at the end of which the managers expect to achieve a target sale price – often to institutional investors wanting mature assets where the remaining source of returns is primarily income.

Another key feature is the diversity. Although NEC's expertise is in solar power, the structure of NREN will allow them to build a portfolio exposed to other sources of renewable energy as well as related technologies, using the expertise of third party managers specialising in those assets. Wind power is the other key renewable source, but NREN could also invest in hydroelectric power and other sources, including emerging options such as hydrogen and in battery storage, increasingly being recognized as a key area requiring development if the world is going to achieve a transition to a fully renewable future. The seed portfolio includes exposure to hundreds of individual assets across a broad spread of industries, geographies and managers. While diversification is attractive from a risk management perspective, we think a potentially more important feature is how this may allow NREN to follow emerging trends as world governments struggle with how to achieve their lofty policy goals. However, from the retail investor's

Seed Portfolio

FUND	1 (NEC)	2(NEC)	3	4	5
Target Size	$750m	€750m	£400m	£500-700m	$2,500m
Investment Strategy	International Solar	Italian Solar	UK Clean Energy	US Clean Energy Fund	Global Renewables
Return Target	13-15% gross	10-12% gross	11.5% net	TBC	12-13% gross
First close	Nov-18	H1-21	Jul-19	Jan-20	Dec-19
Final close	Jun-21	TBC	TBC	TBC	Upcoming
Potential NREN investment (up to)	$100-150m	E50-100m	£40m	£50m	$75m

FUND	6	7	8	9	10
Target Size	E5,500m	€500m	€500m	AUD$750m	€1,500m
Investment Strategy	Global renewables within Infra	European Renewables	Nordics Wind	Australian Renewables	Global renewables
Return Target	TBC	TBC	8-10%	TBC	TBC
First close	Jun-20	Jul-20	Jun-20	TBC	TBC
Final close	Upcoming	TBC	TBC	Unlisted unit trust	TBC
Potential NREN investment (up to)	$75m	E50m	E50m	$50m	$75m

Source: NEC

perspective the diversity of the portfolio will bring some complexity, as does the strategy of investing via third party funds. Potentially this could make it harder to understand and track the portfolio, although this depends on the level of reporting by the manager.

There has been a large sum of money raised for renewables infrastructure trusts in recent years (see **discount** section), and this mirrors huge appetite for investing in the sector globally. Alternatives specialist PEI Media estimates $35bn was raised globally for renewable energy funds over the past five years. However, they record that a further $27bn of investment was being sought by funds investing in the space. This is still small compared to the $10.3trn which Bloomberg New Energy Finance estimated in 2019 would have to be invested in renewable energy generation by 2050. A growing number of countries are targeting net zero carbon emissions, which means the demand for assets is only likely to increase. Meanwhile from the investment side, institutions are seeking investments which align with their ESG objectives, which means renewable energy is much in demand.

One effect of the wave of money coming into the space could be a reduction of returns. This has already been seen in the more mature markets such as the UK, Ireland and France. NREN's global remit means it will be able to focus on the more lucrative OECD jurisdictions as they evolve over time. This could also include investments in emerging markets at times, although this would be expected to be marginal exposure. Notably NEC has extensive experience operating solar assets in India, for example. However, given the ambitious policy goals of many governments, the sector should still require huge amounts of capital, even if the best opportunities in mature markets may shift to battery storage or other ancillary developments.

While the aim is to invest in assets at an early stage, exposure to the construction stage is expected to be minimal. The seed portfolio will not have any assets at this stage, although funds in the portfolio might invest small amounts in such projects as time goes on. The strategy with the third party co-investments will be to invest in portfolios when they have already built up their pipeline and there is visibility on the end portfolio, which means most likely nearer to the final capital raise than the first. Of course, there will also be a track record of performance on these assets. Seven of the ten investments in the seed portfolio above have already completed their first capital raise, with one of the three remaining an in-house solar fund over which NEC has full visibility.

The potential for direct co-investments brings more opportunity. These are effectively fee-free options which will be offered to NREN as investors in third-party funds. Co-investments will be in single assets or portfolios which would typically be invested in on a no fee and no carry basis, as NREN would effectively be investing as a peer with the third party manager rather than as a client. NREN would be able to select the most attractive assets from the private funds for investment in terms of return profile for the co-investment, based on the track record demonstrated within the funds it already invests in. This sort of investment requires another layer of due diligence and a huge amount of expertise and skill which NEC believes it is well-resourced to provide, with over 200 professionals on the books and an extensive track record of private investment in assets and portfolios. It may raise the single asset / project risk for investors in the trust depending on the size of the investors, but as we discuss in the gearing section any long-term debt will be taken on at the asset or project level, with lenders' recourse limited to each secured asset. NREN's targeted returns of 9-11% are net of the cost of debt.

On a shorter-term basis, gearing will be used to bridge the gap between commitments and equity raises to support the expansion of the portfolio. We understand it may also be used to support the dividend if required, as there will be a lag between investment and income receipts (see **dividend** section). This will also ensure there is limited cash drag on NAV.

The investment portfolio is thus expected to be more dynamic than a typical renewables fund, with asset allocation varying as assets mature and are sold. Some funds seek to invest in a portfolio of assets and then manage them indefinitely, but NREN will likely see a more significant level of turnover – although the typical investment horizon is still 7-10 years.

As well as the benefits in terms of return and diversification, this approach will also we believe help to grow renewables capacity in the global economy, which is of huge value if clean energy targets are to be met. The potential for investments in battery storage and emerging technology could be particularly significant in this regard. However even in solar and wind power, investors in NREN will be investing in earlier stage assets and potentially in emerging technologies as well as possibly in geographies in an earlier stage of the transition, as opposed to investing in mature markets where the availability of capital is no longer in question.

Gearing

The intention is for NREN not to take on long term structural debt at the fund level, although there will be potentially significant levels of gearing at the asset level. The manager will also be permitted to borrow for short term purposes using a revolving credit facility in order to invest in new opportunities before fresh equity is available. The approach will be to invest the IPO proceeds in the first two pillars of the strategy, the existing NEC private

fund and existing third-party funds, and to set out to identify opportunities for co-investment with those third party managers which could require the use of gearing as short-term financing. Although the articles provide for up to 50% of GAV (100 of NAV) to be drawn down for such short-term financing, the board currently intends to permit a maximum of 30% of GAV (c. 42% of NAV).

It is worth highlighting the potentially substantial gearing at the asset level, although no target level or maximum has been set. This project level debt will be via special purpose vehicles (SPVs) in order to keep it at arm's length from NREN and ensure there is no recourse to the rest of the portfolio in the event of any repayment issues. Whilst gearing does add to risks, in this case given it is not at the portfolio level, there are likely to be limited repercussions for NREN beyond the value of the individual investment (or income derived from it) should there be any breach of covenants. There is likely to be some opacity in the reporting of this debt however, as it will be off balance sheet for NREN and therefore not detailed in the report and accounts in the same way portfolio level debt would be.

Performance

NREN will target a NAV total return of 9-11%. Although this is without the use of leverage at the fund level, it is worth being aware that this may involve significant levels of gearing at the project level which boost potential returns (see **gearing** section), but also potentially add to risks. The targeted returns include a target dividend yield of 5.5% on NAV, growing each year, implying that considerable capital returns are expected too. We understand that this high expected return is thanks to the superior potential of private funds. The funds the managers anticipate investing in are able to seek out projects with superior economics, using expertise to take greater risks which bring along greater rewards. They are typically investing at an earlier stage in a project's lifespan with a defined exit strategy and multiple in mind, rather than investing in mature assets in an attempt to earn consistent long-term dividends. The typical life of a project within the private funds targeted by NREN is 7 to 10 years, with investors aiming to achieve considerable capital gains along with the income from the project.

The targeted returns from the funds in the seed portfolio below indicate the upper end of the return target may be achievable, although fees at the portfolio level need to be considered too and return targets are not yet available for all the investments. NEC hopes to be able to make sizable investments in new funds and projects as it grows the fund over time, which the managers hope will allow NREN to negotiate favourable terms.

The table below, sourced from JPM Cazenove, shows the targeted returns for the existing Renewables Infrastructure trusts, as compiled by JPM Cazenove. NREN's target is higher by some way than all except Gore Street Energy

Seed Portfolio Target Returns

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Target Size	E5,500m	E500m	E500m	AUD$750m	E1,500m
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Potential NREN investment (up to)	$75m	E50m	E50m	$50m	$75m

Source: NEC

Storage Fund, which invests in the less mature battery market (we note not all figures in the table are net of fees). Certain markets for renewable energy have become more competitive, the manager tells us, meaning that expected returns have fallen. This has led some vehicles, including the NEC's solar investment trust NESF, to broaden their geographical remit beyond the UK and similarly mature jurisdictions. NREN's flexible strategy is designed to allow the managers to allocate to countries and sectors with more attractive returns as the market evolves, hopefully maintaining high return potential over the long run. It is worth noting that the below table illustrates return targets, and there is no guarantee that any of these vehicles will achieve them.

Targeted Returns Of Renewable Funds

NAME	TARGETED RATE OF RETURN (%)
Aquila European Renewables Income	6-7.5
Bluefield Solar Income	7-9
Foresight Solar	7-8
Gore Street Energy Storage Fund	10-12
Greencoat Renewables	7-8
Greencoat UK Wind	8-9
Gresham House Energy Storage	8
JLEN Environmental Assets	7.5-8.5
NextEnergy Solar	7-9
Octopus Renewables Infrastructure	7-8
Renewables Infrastructure	8-9
SDCL Energy Efficiency Income	7-8
Triple Point Energy Efficiency Infrastructure	7-8
US Solar Fund	7.5

Source: JPM Cazenove

Dividend

NREN will target a dividend of 5.5p a share from January 2022, with 3p a share to be paid for the period from launch to December 2021. Assuming the investment programme proceeds as planned, the managers expect the dividend to grow year on year, and form a part of the targeted 9-11% annual total return on NAV. Dividends will be paid in equal quarterly installments after December 2021, with the first dividend after launch paid for the period ending June 2021.

NEC operates a policy of fixing the majority of its expected revenues on its own funds, both NESF and the private funds which will form one third of NREN's portfolio. For NREN, it will prioritise projects which provide fixed revenues linked to inflation where those are available and attractive. Currently NextEnergy Power III, one of two seed investments for the in-house pillar of the portfolio, has 70% of its revenues fixed over the life of the fund's 10 year expected life. The managers tell us they would expect third party funds to operate a similar policy of fixing a prudent level of revenues via such agreements. In fact, a key selection criteria for third party funds will be the ability to provide fixed revenue streams. There will likely be significant exposure to power prices, although by fixing out into the future the exposure can be focused on forward prices at the time of fixing rather than their fluctuating spot level.

With the strategy designed to be flexible and multi-asset, the proportion of revenues that are fixed are expected to vary over time. That said, dividends are expected to be paid from distributable earnings on the underlying investments, which includes unrealized gains on investments, so cash cover is not an objective. This is in part due to the lumpy nature of investment in private funds and co-investments and the lag in income receipts, plus the fact the private equity style of investment is focused on a total return over a time-limited investment horizon rather than an indefinite investment in an income-producing asset. The use of an RCF will ensure timely payment of quarterly dividends regardless of actual distributions from underlying funds.

The 5.5p dividend target is not particularly high compared to peers and would be the median figure in the AIC Renewables Energy Infrastructure sector. However, we think the global, flexible mandate should provide some security regarding the long-term dividend growth potential, as the managers should be able to continually seek out higher yielding projects as certain markets mature. It should also be viewed in the light of the high total return target of 9-11%, and the overall strategy to take advantage of the greater potential for capital growth in private funds.

Management

NREN will be managed by NextEnergy Capital IM (NEC), part of NextEnergy Group. NEC specialises in solar assets. As well as the investment trust NextEnergy Solar, NEC manages a number of private funds which will provide one of the three main structural pillars of NREN's strategy, and in total manages over $2.3bn in renewable energy assets. NEC was founded in 2007 by Michael Bonte-Friedheim, who previously worked in the European energy and power teams in multiple investment banks, most recently Goldman Sachs. Michael is the CEO, and the CIO is Aldo Beolchini, who joined NEC in 2008 from investment bank Morgan Stanley.

Although NEC operates in the solar market, Michael has experience in managing assets from other sectors,

including hydropower and nuclear as well as hydrocarbons. In the NEC team there are 200 professionals, who also bring experience of other fields to the table. However, the structure of NREN is designed to harness the talents and experience of the best management teams across the market. Michael argues that private funds often attract the best managers as they offer superior returns via extra complexity or risks which require sophisticated management. NREN is designed to be able to benefit from the talents of the best in each specialist field, contributing to its high expected total return. The philosophy is that 'specialisation brings alpha'.

The NEC team have set up three private funds investing in private assets which gives them inside knowledge of what to look for in the due diligence process on external investments. They also intend to continue to add to the team in relevant areas as time goes on, having grown from 4 to 200 professionals since they were founded in 2007. The NEC team's experience is deep, and they have developed numerous projects for internal and external management. NEC's work as a developer gives it a constant pipeline of projects it can cherry-pick for its solar funds, public and private. It also has experience developing and managing subsidy-free projects, likely to become an ever larger part of the market.

NEC also has a fully-owned subsidiary Wise Energy which carries out asset management for NEC and external owners, and extends their knowledge down to the technological and operational level. WiseEnergy works for notable names such as Actis, InfraRed, Greencoat, Canadian Solar, Partners Group, Solarpack and RTR, which broadens NEC's knowledge of the renewables market, especially solar, and brings strong contacts with potential third party managers and coinvestors.

Discount

The board will have the ability to repurchase up to 14.99% of the shares in issue in order to control the discount. There is also the possibility of a continuation vote depending on the success in raising funds. If less than £500m is raised, a vote must be held in the three years after IPO, and every five years thereafter. However, the managers intend to grow NREN over the long run. This would be via a revolving credit facility in the short run, to facilitate speed of deployment, with equity raises to follow in order to maintain the aim of a structurally ungeared position. This would likely require the shares to trade on a premium to NAV, which we believe is feasible given the long-term trends in the renewables space.

The market has shown huge appetite for renewables infrastructure in recent years. In fact, according to the AIC, renewable energy infrastructure trusts have raised the most capital via secondary fundraisings for two years running, £1.3bn in 2020 after £1.8bn in 2019. Two of the six IPOs in the investment trust sector last year were in the renewables space too, raising a further £250m between them. Despite this activity, according to JPM Cazenove, as of 01/02/21 the average premium in the renewables sector was 11.6%, with every single trust trading above par. By comparison, NREN's shares will be issued at a premium of 2% to the initial NAV, although clearly the trust will bear some acquisition costs as well as take time to actually invest the capital into assets (so the effective 'premium paid' may be higher).

There are good reasons to think strong demand for the sector will remain. The huge expansion of capacity required by developed world policy goals will likely eventually lead to returns being eroded in certain segments of the market, but equally it will require the development of new sources of energy, new methods of storage and distribution which – market dynamics dictating - should still offer attractive rates of total return. NREN will have the flexibility to seek out opportunities as the market develops. Meanwhile the attractiveness of long-dated income looks likely to be a structural theme for many years (see **dividend** section). We note there is currently also strong demand for real assets, not just renewables, perhaps due to their resilience as well as the sources of income they supply. Real assets can potentially provide a hedge for inflationary environments and sources of return uncorrelated to equity markets, and may be attractive given the current global low yield environment and considerable macroeconomic uncertainty in the aftermath of the pandemic.

Charges

NREN is expected to offer an attractive fee structure compared to the established peer group, although there is some potential variability due to the performance fee. The target OCF is 0.6%, inclusive of an expected 0.4% base management fee. This management fee would be the lowest in the AIC Renewables Infrastructure peer group, although within this group fees are typically tiered, with charges falling as the funds grow, so an average is not very informative. As an example, NextEnergy Solar charges a management fee of 1% on the first £200m, 0.9% on the next £100m and 0.8% above that.

The expected management fee is an estimate based on different management fees applied to each type of investment. NEC will charge a 10bps admin fee on its own funds, expected to make up around a third of the portfolio. It will charge a management fee of 50bps on third party funds, another third of the target portfolio, and 70bps on co-investments. The management fee is therefore likely to be lower in the first accounting period as the more expensive co-investments will not be made on day one.

NREN will pay NEC a performance fee assuming a minimum target total return of 8% is met. Above 8% NAV returns, the manager will receive 15% of the returns. This will be spread over two years, with the second payment made in shares and only if the portfolio has managed to maintain outperformance for the second year too (a clawback provision). Some investors don't like performance fees, but in our view they provide a strong incentive to the manager, particularly when coupled with a lower base fee. We note that were the trust to hit its 11% return target, the performance fee would be 45bps, making the OCF inclusive of performance fees still only 1.05% (on current projections), and so below the 1.14% average reported by the AIC for the sector.

The underlying funds (although typically not co-investments) through which NREN makes investments will also pay fees on commitments made of between 0.75 to 1.75% per annum, plus any carried interest provisions. Over time, as the investment period ends, these will reduce to 0.25-0.5% of invested capital. We understand from NEC that these fees are expected to be towards the lower end of this range, once they have negotiated with each manager and included rebates etc. They note that as a result, investors are only likely to pay two layers of management fees on a third of the portfolio (ie the third party funds). They also point out that the return targets for all investments of 9-11% is net of underlying fees. We understand that underlying management and performance fees will not feature in the KID RIY, which is expected to be low, at 0.7% on launch.

ESG

NREN offers investors the chance to contribute to increasing renewables capacity in the global economy, which is essential if policy goals on reducing carbon emissions are to be met. For this reason we think it has strong ESG credentials even within its sector. As well as investing in assets currently in construction, NREN will be investing in earlier-stage assets which should help grow the pie, with a lot of the institutional money that is currently coming into the sector focusing on buying mature, de-risked assets.

As for the environmental impact of the fund, the management team estimate that at £300m, the target size for the IPO, the portfolio would deliver the electricity usage of 385,000 UK households, or almost 1 million people. It would also be equivalent to taking almost 750,000 cars off the road. Obviously, were the fund to grow as intended this impact would also grow.

Going beyond the obvious environmental credentials, the manager NEC has incorporated the UN's sustainable development goals within its investment strategy and operational practices. NEC views itself as leading the transition to a more sustainable economy, and its sustainability policy centres not just around climate change but also biodiversity and human rights. The commitment to reducing emissions which lead to climate change is self-explanatory. As regards biodiversity, NEC has a dedicated team devoted to it who are working with external partners to ensure the impact on flora and fauna is considered fully across its funds. As regards human rights, NEC includes human rights commitments within its contracts with all counterparties, ensuring they are respected across the whole value chain. NREN will conduct due diligence on the ESG policies of the third party funds it invests in to ensure they have the right policies in place ot be in alignment with these goals. Analysis will be done on the fund level and the asset level. This will extend to ensuring each asset has the right permit and management system in place and is designed and operated in accordance with national and international standards.

NEC also makes annual contributions of 5% of its profits to the NextEnergy Foundation, an independent charity which aims to reduce carbon emissions, provide clean energy where it isn't available and contribute to alleviating poverty. Founded in 2016, the foundation has disbursed almost £400,000 to recipients in 24 countries in support of 10 of the 17 UN sustainable development goals. NEC is a committed signatory of the UN backed Principles for Responsible Investment and is a member of the Institutional Investors Group on Climate Change and a supporter of the Task-Force for the Climate-Related Financial Disclosure. For more information on NextEnergy Foundation, please **click here**.

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