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Renewable energy trusts seek growth after subsidy loss

By Emma Agyemang

Renewable energy trusts invest in wind and solar generation and are popular with investors due to their high, inflation-linked and government-backed yields. The average investment trust within the Association of Investment Companies (AIC) Infrastructure - Renewable Energy sector is trading on a 9.6 per cent premium to net asset value (NAV). The yields these trusts are currently generating have been partly driven by generous subsidy schemes, with around 60 per cent of fund revenues coming from this source. But March saw the closure of an important subsidy – the Renewables Obligation Certificates (ROCs) scheme – to new projects, raising the question of how renewable trusts will continue growing in future.

Subsidy reductions

Launched in 2002, ROCs were the government's primary way of subsidising large-scale renewable energy projects in the UK. They were issued to producers of renewable energy accredited by energy regulator Ofgem for each megawatt hour (MWh) generated and lasted for a period of 20 years, as well as being linked to retail prices index (RPI) inflation. These certificates could then be sold to other energy suppliers, as part of the Renewables Obligation that required all energy generators to deliver a chunk of their energy from clean sources.

As well as the proceeds from the sale of ROCs, renewable energy trusts typically receive revenue from two other less predictable sources. Trusts receive revenue from the clean energy sold by wind and solar projects (among others) to the open market or through long-term power purchase agreements (PPAs). They also receive income from penalties imposed on other energy producers unable to meet their renewable obligation, which is distributed among those awarded ROCs.

The withdrawal of ROCs has left just two other subsidies available to the renewable energy sector: feed-in tariffs (FITs) and contracts for difference (CFDs).

FITs are designed for smaller energy providers and pay renewable energy suppliers a set rate for each kilowatt hour (KwH) of electricity generated. Additional income is earned for

electricity exported to the energy grid. Although tariff levels are RPI linked, FITs are only available for smaller renewable energy installations with a declared net capacity of 5 megawatts (MW) or less.

CFDs are available for projects with a capacity larger than 5MW. Under this arrangement, projects will receive the market price for the electricity produced, plus the difference between the market price and an agreed strike price. If the market price is below the strike price the renewable energy generator will receive a payment and vice versa. Although CFDs will eliminate exposure to the power price, the revenue received will be consumer prices index (CPI) linked rather than the more generous RPI. And the subsidy will be available for a shorter time period of 15 years rather than 20 years for ROCs.

CFDs are awarded by auction and there is no guarantee that a renewable energy project will be successful in the auction and receive a CFD subsidy.

Growth without subsidies?

Although new renewable energy projects are no longer able to apply for ROCs, existing projects subsidised under the scheme will continue to receive their full 20 years of ROC subsidy, meaning that newer projects still have many years of generous subsidy income ahead of them.

That means that one route for renewable energy trusts is to buy those older renewable energy projects on the secondary market. However demand for renewable projects means valuations are high.

"Pricing of the assets has got so high that the potential yield doesn't fit in with the managers' objectives," explains Iain Scouller, head of investment company research at Stifel. "In terms of growth opportunities, it's difficult to find things to buy at the right price in the UK, which is why some funds are sitting back [and not buying new assets]."

Another route to improving income over the long term is to diversify projects overseas. "Other funds are considering making investments overseas," says Mr Scouller. "The returns are higher than you can achieve in the UK and I think from the shareholder's point of view it brings some diversification."

Examples of trusts expanding overseas include **NextEnergy Solar Fund** (NESF), a solar fund that amended its investment policy at its 2016 annual general meeting (AGM) to invest in non-UK solar projects within Organisation for Economic Co-operation and Development (OECD) countries.

And **Foresight Solar Fund** (FSFL), which invests in ground-based solar assets, is expanding its range of assets beyond the UK into locations in western Europe, US and Australia. Of its current pipeline of assets, which have a capacity of 500MW, about 40 per cent are international projects.

Kieran Drake, research analyst at Winterflood Securities, thinks overseas diversification can be beneficial. He says: "A fund that has wind assets in the UK and in Europe, for example, can benefit from that diversification in different weather systems, where it could be a quiet year in the UK for wind but a windy year on the Continent. It can also be helpful to diversify the subsidy regimes."

But despite the potential benefits, adding in overseas exposure also adds in currency risk and so he would expect to see funds hedge their foreign exchange exposure.

Many trusts will also be able to grow without subsidies due to falling costs and improving profitability of solar energy projects. The cost of solar equipment has fallen dramatically in recent years. In 2005 solar panels cost £4 per watt while today the average price is below £0.4 per watt and this is estimated to fall to £0.2 by 2020, Stifel reports.

But so far, NextEnergy Solar is the only trust to start down the unsubsidised solar path. Earlier this year it announced a non-binding investment of around 60MW in development projects that will operate without any subsidies, although management believes this will not be financially viable for another 12-24 months.

Mr Drake says: "Some trust managers have said that [unsubsidised solar] is on the horizon, but in the event investors would be looking for a higher return as it's a bit more risky. Originally one of the big attractions with renewable energy was that the income was government backed. If it's subsidy-free, the projects will be fully exposed to the power price. That's not to say that it couldn't work as the price of solar panels has come down quite quickly, it's just how quickly that continues to drop."

Increased exposure to power prices will make revenue more volatile compared to the inflation-linked, government-backed income streams. If power prices go up then funds could benefit, but if power prices fall for several years as has happened recently, this could have a negative impact on the trusts' ability to pay and/or grow dividends.

"Power prices continued their downward trend over recent months, with all of the funds adjusting their power price curve downwards to reflect forecasters' decreased expectations," says Mr Scouller. "Funds which have published assumptions expect power price growth of RPI + 1.6 per cent to 1.9 cent and should the decrease continue, we would expect dividend cover to diminish."

Diversifying clean energy projects

A different strategy for increasing growth is to expand the type of assets a trust invests in. Earlier this month **John Laing Environmental Assets** (JLEN) acquired its first anaerobic digestion plant for £15.3m, a move that further diversifies its portfolio of solar, wind and waste and water management projects. The plant, which is located near Doncaster, predominantly produces biomethane. It was commissioned in October 2013 and was the first commercial biogas-to-grid in the UK. The plant is accredited under the Renewable Heat Incentive (RHI) and FITs which generate RPI-linked revenue streams.

And at its 2016 AGM, **The Renewables Infrastructure Group** (TRIG) received approval to up its investment in technologies other than wind and solar to 20 per cent, from 10 per cent. In August it acquired a 20MW battery-storage project which is currently under construction in West Lothian, Scotland. This is due to be operational in the second half of 2018 and have an operational life of 15 years. It benefits from a bespoke contract with National Grid Electricity Transmission to provide dynamic, two-way grid balancing services. For the first four years of operation, revenues are substantially based on pre-determined RPI-indexed payments.

The trust's managers believe that the use of battery storage is becoming more important to enable grid networks to match fluctuations in the supply and demand of electricity and to stabilise power frequency.

James de Bunsen is manager of **Henderson Multi-Manager Absolute Return Fund** (GB00B8113P38), a fund of funds that has several alternative asset funds, including TRIG, within its portfolio. He says: "TRIG is diversifying into battery storage, which is an area that could be a real game-changer for the industry. Traditional oil and coal can produce energy whenever they want but at the moment the storing of electricity produced from renewable energy is difficult. But if the development in batteries moves on in leaps and bounds and you can more efficiently store electricity that would be a benefit to this trust and National Grid would have a more reliable source of power. It’s not a huge departure for TRIG (as it’s only a £20m project) but you can see how it adds value." However there are also risks with investing in a new technology where a trust does not have a previous track record.

Trusts can also wring out further income from the projects they do own, rather than acquiring new projects. **Bluefield Solar Income Fund** (BSIF), the highest-yielding trust in the sector at 6.4 per cent, is currently taking this approach. It has a team of 40 staff who focus on how to maximise revenues within the fund’s PPAs or via cost reductions in existing contracts. In addition it has a team of technical engineers who

continually monitor their solar plants to see how they can improve efficiencies and generate more power.

"The model that we adopted from our Initial Public Offering (IPO) was that of building, with the vast majority of the portfolio – over 80 per cent – acquired through funding via construction as we took advantage of the rapidly growing solar market in the UK," says James Armstrong, managing partner of Bluefield partners, investment adviser to Bluefield Solar Income. "Whereas what we are looking at [now] in a steady state is how we can drive earnings growth, which is what our shareholders want."

The various methods funds are using to continue growing suggest they have largely taken the loss of ROC subsidies in their stride, however new acquisitions may potentially change their risk/return profile going forward.

"The loss of the subsidies doesn't help, but it's not going to be a disaster for the trusts," says David Liddell, chief executive of IpsoFacto Investor. "Subsidies remain in place for the existing assets so the existing portfolio shouldn't be affected. Really, it's the extent to which they invest in new projects. There are assets they can acquire but it'll be a matter of price and return and how it fits with the overall portfolio."

"The fact they are all trading at premiums shows the market thinks they are still sound investments and they continue to pay nice, attractive dividends," adds Mr de Bunsen. "[Even with the] lower power prices and regulatory changes in the past few years, they've held up really well and that's quite reassuring for us as investors."

Renewable energy fund tips

John Laing Environmental Assets invests across solar, onshore wind, waste processing and wastewater projects. The trust is trading on a premium of 8.1 per cent and has a yield of 5.8 per cent.

Mr Liddell says: "I like John Laing Environmental Assets as the premium is not as high as other renewable energy trusts and it's got a diversified exposure to solar, wind and waste and now its new investment in anaerobic digestion, which makes it not so exposed to any one of these areas."

As well as its range of investments, John Laing Environmental Assets seeks diversification in its geographic exposure. The fund has projects in the UK, which must represent at least 50 per cent of NAV, and France. It is also able to invest in projects located in OECD countries.

Most projects are operational, with no more than 15 per cent of the fund's NAV invested in projects that are in construction or not fully operational.

The trust aims to pay a long-term sustainable dividend that increases in line with inflation and to preserve the capital value of its portfolio by reinvesting cash flows not reserved for dividends. It is targeting a full-year dividend for the year ending 31 March 2018 of 6.31p.

The Renewables Infrastructure Group also seeks diversification across a range of environmental assets and geographies. This fund invests in 56 wholly owned assets in the UK, France and Ireland, which consist of a mix of wind farms and solar projects. Wind projects account for around 75 per cent of the trust's portfolio, with solar accounting for around 25 per cent.

Mr de Bunsen holds the trust within Henderson Multi-Asset Absolute Return, which makes up around 3 per cent of the portfolio. He recently cut this exposure from 3.5 per cent, to take profits and in anticipation of a possible equity issuance when he plans to top up again at the cheaper premium. He likes the total returns on offer and the fund's geographic diversification.

"TRIG has got Irish and French assets; the key for us is to ensure the subsidies regimes that [the projects benefit from] are similar to the UK in terms of legal and property rights," he explains. "Liquidity is also important to us and TRIG is now at a market capitalisation of £1bn."

The trust yields 5.7 per cent and is currently trading at the second highest premium to NAV in the sector, at 12.4 per cent. It aims to pay a dividend of 6.4p for the year to 31 December 2017, an increase of 2.4 per cent on last year's dividend. But analysts at Stifel suggest that the trust may move away from paying an inflation-linked dividend increase in 2018 and instead start paying a progressive dividend. They are negative on the trust only because of its current high premium, but think that if it issues further shares at a lower premium, this could be an attractive entry point.

Greencoat UK Wind (UKW) is another trust that analysts at Stifel suggest could be a good opportunity if the trust issues further shares at a lower premium to NAV. Currently the trust is trading on the highest premium of the sector at 15.3 per cent.

Maarten Freeriks, associate, investment funds research at Stifel, says: "We continue to rate the management team and like the conservative nature of their assumptions. With the fund very much having exhausted its current debt financing capabilities, we would hope to see a more attractively priced opportunity to buy the shares in a capital raise and hence apply a negative recommendation for now purely on a valuation basis. We continue to believe the fund has many attractive attributes and should continue to trade on a significant premium given the lack of movement in the discount rate, strong dividend cover and good liquidity profile."

Greencoat UK Wind is the only renewable energy fund to focus purely on wind farm investments and has the second-largest market capitalisation, at £920m. It is yielding 5.1 per cent.

The trust aims to provide investors with a sustainable annual dividend – of 6.49p for 2017 – that increases in line with RPI inflation while preserving the portfolio's capital value in the long term.

It invests in operating UK wind farms that typically have a capacity of more than 10MW. Exposure to offshore wind is limited to 40 per cent of gross asset value and currently make up 6 per cent of the portfolio.

Meanwhile any investment outside the UK or in construction projects or in non-equity or associated debt instruments are limited to 15 per cent of the fund's gross asset value.

Foresight Solar Fund is another fund that Mr de Bunsen uses within Henderson Multi-Asset Absolute Return. Foresight differentiates itself from its peers by purchasing significant scale assets, holding 18 assets in the portfolio, all of which are fully operational under the ROC accreditation.

This fund aims to provide investors with a sustainable dividend that increases in line with RPI inflation, together with the potential for capital growth over the long term, by investing in a diversified portfolio of operating UK ground-based solar power plants.

The trust is targeting a dividend of 6.32p for the year ending 31 December 2017. It is currently yielding 5.7 per cent and is trading on one of the lowest premiums to NAV in the sector at 7.3 per cent.

Mr de Bunsen says: "Foresight are in particular looking to grow their exposure to Australian solar, which although it has not had such a favourable subsidy strategy [as the UK], has better returns. Australia also has plenty of space for solar farms and a lot more sunshine."

Renewable energy trust performance

Fund	Yield (%)	1-year share price return (%)	3-year cumulative share price return (%)	Premium to NAV (%)	Ongoing charge figure (%)*
Bluefield Solar Income	6.4	13	33	4.6	1.12
Foresight Solar	5.7	13	25	7.3	1.20**
Greencoat UK Wind	5.1	17	35	15.3	1.37
John Laing Environmental Assets	5.8	10	24	8.1	1.46
Next Energy Solar	5.6	15	29	9.2	1.28
Renewables Infrastructure Group	5.7	16	26	12.4	1.09
AIC Renewable energy sector average	4.9	14	29	9.6	na

Source: Winterflood Securities as at 25/09/17 *The Association of Investment Companies **Morningstar as at 25/09/17