

Commentary: The opportunity for LPs in the renewable energy revolution



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Institutional investors remain substantially underexposed to a dynamic and rapidly growing segment of the energy sector: renewable energy generation. While traditional power generation capacity has stagnated over the past 10 years, wind and solar generation have jumped 470%, according to a report by Bloomberg New Energy Finance. Even traditional utilities, traditionally slow to embrace new technologies, are recognizing the long-term growth trajectory for renewables based on falling cost. Xcel Energy Inc. CEO James Robo told Utility Dive in July, "We're looking at (prices) in the low teens to low 20s (in dollars per megawatt-hour for renewables). ... That beats (natural) gas, even at today's prices."

Clean energy generation has more than doubled since 2010, while overall U.S. electricity consumption and generation has remained flat during the same period. Estimates suggest this uptick is no aberration. The Bloomberg New Energy Finance report indicates solar, wind and other clean technologies will make up half of the global energy mix by 2030.

After considering the data, it is natural to wonder why many pension funds, endowments, insurance companies and large institutions have been slow to invest in renewables. The answer has a lot to do with conventional asset allocation and portfolio construction philosophies.

A small slice

The energy sector, including both power and fuel, accounts for 7.3% of the U.S. stock market's capitalization. But companies focused on renewable energy technology, equipment and generation make up just 0.01% of that total, which means institutional investors pursuing a market-weighted portfolio of public equities are heavily invested in conventional energy, with very little exposure to renewables.

With few pure renewable energy opportunities available in the public markets, institutional investors have turned to alternative asset managers to fill the void. A recent report on alternative assets from Preqin revealed 34% of institutional investors considered renewable energy their preferred strategy.

Drivers of growth

As the limited partner community recalibrates its view of the energy sector, it can take comfort in the sustainable factors driving growth in the renewable portion of the market:

New cost-efficiencies and technological advancements. The cost associated with solar and wind generation technology has declined dramatically over the past decade. Solar module costs, in particular, have fallen more than 70% since 2010. Wind turbine technologies also continue to improve due to increasing turbine sizes, blade lengths and tower heights. Thanks to strong advances, the cost of electricity produced by these technologies now rivals natural gas and is lower than both coal and nuclear generation in most parts of the country. Innovations in battery and other energy storage technologies, as well as transmission and distribution management controls, are also helping to increase dependable access to solar and wind power.

Surging corporate demand. Corporations across the world are publicly committing to move to renewables from legacy energy sources. According to RE100, a global initiative of influential businesses, upward of 125 companies already have pledged to go "100% renewable" in the coming decades. This group includes influential global brands such as Adobe, Citi, Google and Starbucks.

Not surprisingly, Deloitte notes in its 2018 outlook on renewable energy that the momentum behind corporate demand is poised to increase. The report highlights that "mandate-driven procurement has been eclipsed by voluntary procurement" thanks to attractive prices for solar and wind power generation. Meanwhile, corporations are increasingly adhering to society's expectations when it comes to environmental, social and governance standards. More than 95% of the world's 250 largest companies by revenue now issue sustainability reports disclosing environmental and social impact.

Economic challenges for legacy energy providers. With coal plants being retired and the U.S. nuclear revival stalling, large institutions naturally are reluctant to invest in legacy energy providers. Diminished customer demand, environmental concerns, rising debt loads and commodity market volatility are all factors plaguing these once-viable corners of the sector. Meanwhile, more than 50% of U.S. power generation facilities are now more than 30 years old and approaching the end of their useful life. Replacing a significant portion of this capacity with renewable generation offers an enormous investment opportunity.

Although the public market opportunities in the sector are too small now to satisfy demand, there is an array of experienced private managers deploying substantial capital into low-risk renewable energy assets. This is perhaps the best path for institutions seeking to capture consistent, stable returns while also financing the rise of the new energy economy.

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