KEYNOTE INTERVIEW

Climate infrastructure dominates the energy space

Andy Pike and Keith Derman of Ares Management say climate infrastructure presents a significant opportunity for investors today

The energy sector is one of the main drivers of private investment into infrastructure, especially in the US, where transportation and other segments are largely supported by public programmes. As a value-add investment manager focused on the infrastructure and power space, Ares supports projects throughout the investment lifecycle – from late-stage development through operation until exit. And while there are opportunities to be found in all corners of the market, climate infrastructure is particularly compelling, say partners and co-heads of Ares Infrastructure and Power, Andy Pike and Keith Derman.

Q What are the main areas of focus for Ares Management within the infrastructure and power space?

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Andy Pike: We are a value-add investment manager, and currently focus on three primary infrastructure verticals: gas generation, climate infrastructure – which we define as renewables, storage, electric vehicle infrastructure and energy efficiency – and energy transportation, which includes midstream and electric transmission.

The key to our strategy in these verticals is to invest across the full lifecycle of our investments, from late-stage development to construction, operations and ultimately, to exit.

Keith Derman: We view ourselves as being highly flexible and experienced capital. We can build and we can buy – in other words, greenfield and brownfield projects. We can own and we can operate. Today, we oversee a substantial portfolio of assets that we believe are best in class. We invest in assets and, occasionally, into platform companies. But ultimately, we are seeking the best relative value. Our flexible capital and ability to invest up and down the capital structure by a single team are among our largest competitive advantages.

Q Which of those three areas – gas generation, climate infrastructure and energy transportation – presents the most interesting opportunity?

KD: We have cumulatively invested more than $8 billion in the energy, infrastructure and power sector over the past few decades.

What are the current challenges the US market faces in the wind sector?

KD: Investing in wind is not new for Ares, although our activity level has increased lately. Our team has ties back to Kennetech – a pioneer in the wind sector – and we owned wind projects in the Altamont Pass in California in the 1990s. My first investment with this team in 2005 was a wind devco that we acquired and later sold to Duke Energy, which became its platform into renewables.

But wind is a different industry today. Cost is down and availability and capacity factors are up. Tax credits are rolling off, which is certainly the most interesting dynamic in today's market. This has led to a sprint among developers to get projects under construction and in service, which in turn has caused an inequitable supply/demand balance with respect to key elements of the wind value chain. This relates to the availability of safe harbour turbines, EPC contractors and also tax equity. And this imbalance can create opportunity, which is why we've been so busy in the space of late.

The market has evolved into one that is dominated by opportunities in the climate infrastructure space. This includes wind, solar, batteries, and everything that is driving the energy transition and decarbonization of the power sector.

These changes are at the utility scale and, increasingly, on a distributed basis with commercial and industrial and residential customers. These are the infrastructure opportunities where we see the greatest opportunity, and it is being driven by the substantial cost reductions of wind and solar and their growing cost competitiveness compared with conventional generation.

A key trend is that battery storage is rapidly following the same downward cost curve as solar. Renewables are already the dominant form of new generation, and batteries allow that growth to continue. There is an incredible market opportunity with so much development under way, and with so much capital wanting to own de-risked infrastructure assets that are either low- or no-carbon. We play a value-add role to support projects and companies during development and into construction and operations – and, ultimately, although it seems to be coming quicker these days, to an exit.

AP: Something we think about when approaching an investment is avoiding capital at risk during the high-risk periods of development. We may be involved early to lend our experience and relationships, but we invest when the question is not whether the project goes forward but what it looks like when it does. We gravitate heavily towards late-stage development when there remains a considerable value-creation opportunity and risk-mitigation requirement with respect to the financing and the prime project contract negotiations. We believe these initiatives are some of our greatest strengths.

How will the decline of utility-scale power-purchase agreements and the move towards merchant exposures affect the balance of risk when it comes to sourcing attractive opportunities for investors?

AP: Since the inception of the independent power industry, the market has been supported by long-term PPAs. These were the lifeblood of the industry and helped attract capital as the industry matured and during times of disruption.

Over the years, the revenue model moved from PPAs to shorter contract tenors, albeit with more conservative capital structures. Similarly, renewables are also witnessing shrinking tenors as well as an influx of corporate PPAs driven by low-cost power. The corporates, also motivated by sustainability initiatives, are supporting the continued growth of the market. But for the influx of the corporate PPA, we've seen this movie before, and we are comfortable with the evolution.

KD: I see the industry as a victim of its own success. Risk is getting re-apportioned due to capital volumes and industry participants. We see this as an opportunity as it requires additional structuring capabilities, which plays into our strength. But it also requires considerable discipline.

This is not to say that there are no utility PPAs anymore. We just signed a 20-

"Renewables are already the dominant form of new generation, and batteries allow that growth to continue"

KEITH DERMAN

year PPA with Evergy on a wind project in Kansas. The market and contract pricing have become incredibly efficient vis-à-vis the cost of capital. You need another opportunity for value creation on a project like that and that is a key to our success, we have or can create those opportunities for return enhancement.

Q What differentiates the Ares platform from others in the market?

AP: Ares has a remarkable culture of collaboration and we take pride in the power of the platform. We work collaboratively across the different strategies on both the credit and equity side, leveraging research capabilities, information flow and relationships across the firm to operate as a single entity.

We also have the flexibility in terms of how we invest on behalf of our clients – whether it is debt or equity – and the ability to invest across the life cycle of an asset. We can undertake late-stage development risk and provide appropriate capital at each stage of an asset's or company's life.

Our team consists of credit and equity professionals, some with 30 years of industry experience. Out of our $8 billion invested, over $2 billion representing more than 60 transactions is in the climate infrastructure sector alone. We believe that differentiates us in today's market and gives us a stronger foundation into how to structure deals, how to think about the impact of technology, and how to project forward how the current changes in the market will drive the energy transition.

KD: Despite the growth at Ares – now with $149 billion of AUM and 1,200 employees – it still feels like a partnership. The leadership of the firm know each other, and we get together regularly. It is also standard practice at Ares to populate investment committees with professionals from different business units, which introduces best practices and avoids groupthink. Our investment committee includes the co-head of Ares credit as well as the co-head for North American private equity who is responsible for energy. We get huge value from their insights and perspectives into our decision making. I love that.

Q What are some of the things you're doing right now in the climate space that you see as industry-leading or setting a standard?

KD: We have invested over $2 billion into climate infrastructure, completing about a dozen transactions in the climate space over the past 24 months alone. We've constructed and separately repowered facilities in the wind sector as well as lent senior debt and mezzanine financing to a leading wind developer, purchased a solar EPC company, acquired a utility-scale solar company and capitalised a C&I solar business. We've invested throughout the capital structure in residential solar – equity, mezzanine and senior secured. We even invested in a residential storage company last year. The fact that there is now an economic value proposition to placing a battery into homes never ceases to amaze me. The world has changed so quickly.

"We gravitate heavily towards late-stage development when there remains a considerable value creation opportunity and risk mitigation requirement"

ANDY PIKE

One recent deal that highlights our value-add capabilities is Phoenix Wind, where one of our funds acquired three wind facilities in Texas from BP in December 2018. The assets have been in operation since as early as 2008 and all utilise Clipper turbines, which have underperformed. Ares is planning to repower these projects, which loosely means we keep the towers and foundations but replace the moving parts and the technology like the blades, the nacelle and the gearbox. The goal of the repowering is to maximise the performance of the facilities and meaningfully extend their lifespan.

What is so unique about this transaction is that we are swapping one OEM's machine, in this case Vestas, on to another OEM's. As far as we are aware, that has never been done before. We engaged Vestas to not only provide the equipment but also serve as the EPC and the O&M, giving us a single point of responsibility for price, schedule, performance and availability. I love this transaction because of what it signifies as far as the evolution of the wind sector, but also because of what we believe it says about our team's capabilities.

We also recently announced a partnership with Dimension Renewable Energy around a portfolio of utility-scale battery storage projects located in New York, primarily in Long Island to start with. Zone K is a market we know well from our early involvement in the Neptune Transmission line, which connects PJM to Long Island. Storage is crucial in a densely populated market like Long Island with strict environmental regulations, retiring peakers and a burgeoning offshore wind industry. Dimension is leading development, and Ares will acquire the projects at the start of construction. The total potential size of the portfolio is more than 300MW and 1,200MWh, which is the equivalent of providing 300,000 homes with on-demand power in the region.

And while many investors are looking to get into storage, we have now invested in utility-scale, C&I and residential storage. We believe storage is, on the heels of competitive, unsubsidised wind and solar generation, the defining opportunity set of the energy transition – at least until vehicle electrification becomes ubiquitous and propels the energy transition into the transport sector. ■